

# Strategic Estimate 2019



*Adnan Khan*  
*Khilafah.com*

“According to China’s vision [for the BRI], the long-term effects on the region will be that the renminbi replaces the dollar; customers will use Alipay instead of VISA; authoritarian rule will be consolidated thanks to closer cooperation with Beijing, including in the security domain; families will watch Chinese TV programmes and read the news provided by Xinhua; students, professionals, and political elites will be educated and trained in Chinese universities; internet censorship technology and applications from China’s “great firewall” will cover the region and filter public cyberspace; the spread of universal rights will yield to “development rights;” and finally, Western influence, especially that of the United States, will be relegated to the margins. China, in short, will be the preponderant regional power. That’s the vision that BRI is intended to enable and serve.”

*Roy D. Kamphausen, Testimony before the House Committee on Foreign Affairs, Subcommittee on Asia and the Pacific, 15<sup>th</sup> November 2017, p. 9.*



# Intro duction

*Strategic Estimate* is Khilafah.com's annual assessment of the global balance of power. In our assessment of 2017, we concluded the US remained the world superpower, but it was not the power it used to be. As Donald Trump passed his midpoint as US president, unlike his predecessors he turned the institutions, treaties and tools the US long used as a means to maintain its grip on the world upon its head.

The liberal world order which the US constructed after WW2 has for the last decade at least ceased to serve the US agenda. It was in this background Donald Trump ran for office on a campaign of American retrenchment – making America great, with a host of populist positions that included ending US wars, renegotiating political and economic agreements and changing relations with the likes of China, Russia, Iran and North Korea. This was how the Trump presidency planned to preserve the American position as the global hegemon. NAFTA, NATO, Trans-Atlantic security were all attacked and ridiculed in one way or another as the US has had enough of maintaining the security of others when those same countries contribute little. *Strategic Estimate 2019* will assess where these institutions stand today and will they survive the American onslaught.

In this light, the first National Security Strategy of the Trump government was published in early 2018 and it placed the struggle between powers rather than terrorism as the main threat to the US. Soon after this, the US began a trade war with China beginning

the battle for the 21<sup>st</sup> century. Iran and North Korea were for long viewed as enemies of the US. Nations that are run by oppressive regimes and their pursuit of nuclear weapons is causing global instability. But in 2018 and in-line with Trump's unorthodox style, North Korea was on the receiving end of a summit with Trump, the first time ever, whilst Iran has been thrown under the bus, despite the previous administration's nuclear accord which brought Iran out from the cold. *Strategic Estimate 2019* analyses where both these nations fit into the US strategy in its agenda to remain the global hegemon.

Vladimir Putin was re-elected as Russian president in 2018 and this all took place as US sanctions continue to hurt the Russian economy. Russia has attempted to fight back at the global hegemon through a hybrid and indirect strategy. Whilst Russia has succeeded in saving the regime in Damascus, what role it will play in the country's future remains a matter of debate. In Ukraine, the conflict remains frozen and Russia has struggled to win back the country it lost back in 2014. In 2018 media reports and analysts galore have talked about a resurgent Russia who has humiliated the US not just in Syria but in the wider Middle East. *Strategic Estimate 2019* analyses the reality of Russia's challenge to the US, especially in the Middle East.

The EU continued to face significant challenges in 2018. Trust, scepticism, rising nationalism and different directions. In this light, the French President Emmanuel Macron attempted to lead



returned to using precious metals as its currency. The past few years have seen a plethora of works on the rise of China. From China becoming the world's largest economy, the world's largest exporter and sending missions to the moon, it's difficult to go without a day, without China breaking some new record. China is the rising power and the US now faces the challenge all hegemons do – how to deal with a rising power who is challenging for the top position. Much of the analysis comes from a Western perspective on China's rise, the potential threat as well as its strategy. This ranges from China posing a threat which is out of synch with its capabilities to the US, to the US working to manage China's rise. In *Strategic Estimate 2019* we assess China's rise and its future from a Chinese perspective, answering questions on how the Chinese view the world, the current global situation and their strategy to traverse it.

the reform of the EU as Britain edged closer to Brexit. Both French and German leaders made it clear they will restructure the EU to see through the challenges it faces in the 21<sup>st</sup> century. This began immediately with a strategy on how to integrate the Balkans, the last remaining part of Europe that remains outside the EU. The 3<sup>rd</sup> and 4<sup>th</sup> largest economies in the EU – Italy and Spain saw the emergence of new governments during 2018, which included anti-EU parties. When Britain's very disorderly exit of the union is added to the mix the survival of the EU continues to be at the very core of all discussions. *Strategic Estimate 2019* assesses where all these developments leave the union.

The year 2018 was the 10<sup>th</sup> anniversary of the great recession and this took place as the global economy continued to suffer from the effects of the decade-old crisis. Economic data throughout 2018 proves whatever growth has taken place since 2008 is not sustainable, it is built on unprecedented debt levels and the global economy is due to the next recession which usually takes place every ten years. All of this took place as the US began its assault on global trade attempting to change the rules on international trade. Currencies were a major issue throughout 2018 with leading currencies suffering from falling exchange rates. Cryptocurrencies hit the headlines in 2018 with the rise and fall of digital currencies such as Bitcoin. Whether these digital currencies can become the standard remains to be seen as one US state in 2018

What follows *in sha Allah* is the author's opinion and assessment of 2018 and the trends for 2019 and beyond. Like any assessment, they are estimates and forecasts.

Adnan Khan,  
*23 Rabi' al-Thani 1440 AH,*  
*31<sup>st</sup> December 2018 CE*





*The liberal world order constructed after WW2 for long aided the US in shaping global trade, finance, international security and international law. But in the second decade of the 21<sup>st</sup> century, the US has begun recalibrating its use of these institutions, as well as adopting new mechanisms in their place that more closely fit the challenges that it faces especially the diminished resources at its disposal. This all takes place with the US beginning a war with China in the battle for the 21<sup>st</sup> century as the global hegemon attempts to contain the rising power.*

# Uprooting the Liberal Order

On 25<sup>th</sup> September 2018, US President Trump addressed the 73<sup>rd</sup> session of the UN General Assembly. Standing before probably the only institute that has nearly the whole world as its members, Trump rejected the “*ideology of globalism*” and offered the alternative “*doctrine of patriotism*” wherein “*responsible nations*” must defend against “*threats to sovereignty*” from “*global governance*” and other “*new forms of coercion and domination.*” Despite laughter from world leaders, Trump spoke without irony. In fact, the President’s call for nationalism has found an audience. Interdependence is a fundamental reality of the modern world, Trump is now officially pursuing the great unwinding.<sup>1</sup>

The liberal order the US constructed after WW2 served it well for seven decades. Having contributed in turning the tide in WW2, America was well placed to dictate the terms of the post-war world. The Yalta Conference in 1945 distributed the spoils amongst the victors. However, the year before at the Bretton Woods, New Hampshire, the International Monetary Fund (IMF), the World Bank and the General Agreement on Taxes and Tariffs (GATT) were created. The Brookings Institute confirmed in a report: “*the United States has viewed all multilateral organisations including the World Bank, as instruments of foreign policy to be used in support of specific US aims and objectives...US views regarding how the world economy should be organised, how resources should be allocated and how investment decisions should be reached were enshrined in the charter and the operational policies of the bank.*”<sup>2</sup> All of this required maintaining a military presence in Europe and Asia. In the immediate aftermath of the war, this was manifested in the occupations of Japan and Germany and placing constitutional limits on the size and operations of those countries’ armed forces. Out of this emerged NATO in 1949 as the overarching military structure through which the US security umbrella for Europe was manifested. This supranational organisation would maintain the political



and economic order and possess quasi-legal powers.

During the period of the Cold War, these liberal institutions could not enjoy the primacy the US had hoped for, due to the power and influence of the Soviet Union (USSR) and the Warsaw Pact nations. The USSR repeatedly stymied US initiatives in the UN and also used it as a forum to expose Western powers and their colonial adventures. The influence of the USSR and broad appeal of some of the socialist ideals meant significant restrictions on international trade still presented limitations on the spread of free trade and globalisation. As a result, the US and its liberal allies focused on a strategy of containment, while professing a commitment to progressive social goals that would limit the relevance and appeal of communism.

Whilst the world waited for the huge Soviet military to expand to the East of Berlin, in 1991 an unprecedented opportunity presented itself. The collapse of the USSR and the end of the Cold War led to an unprecedented period of primacy and freedom of action for the US. For the first time in decades, the opportunity now existed for these international institutions to fully serve the aims that the US had envisioned for them in the aftermath of WW2. A now-compliant Russia was willing to acquiesce to a host of American initiatives in the UN, meaning a huge increase in the number of resolutions passed and an uptick in the number of international activities led by that organisation.



# The Unravelling of the World Order

Despite the high hopes as we come close to the second decade of the 21<sup>st</sup> century, it was US actions (or inactions) that have undermined the liberal world order. Russia's successful rollback of the colour revolutions of the early 2000s revealed the shallow extent of the US commitment to its partners in the Central Asian and Caucasus regions. The unopposed invasion of Ukraine has confirmed that the commitment was not sustainable and had never represented a vital US interest.

Serious international crises from Syria and Iraq to Rwanda and the Congo, have shown the impotence of the international community and the failure of the UN and its institutions to provide a serious guarantee for world peace.

The WTO was meant to provide a means for liberal free market states to preach their doctrines to the lesser nations of the world. It was also intended to put greater pressure on emerging economies to follow capitalist prescriptions for reduced government intervention in the

market and greater involvement of the private sector in the provision of public goods such as water, energy, education and healthcare. This was particularly intended to be a means of taming the aspirations of China, Russia and other growing industrialised economies. However, the Doha Development Round of negotiations, intended to run only from 2001 to 2005, and to address the perceived inequities of treatment of developing countries, have still not concluded and have broken down altogether.

On the domestic front, the much-vaunted financial sector has proved to be an Achilles's heel rather than a source of strength for the global economy. Following the global financial crisis, the institutions and trade agreements that underpin the international markets are now seen as part of the problem rather than the solution.

For broad swathes of the population of Europe and America, that see manufacturing jobs moving abroad and service jobs drawing in aspirational immigrants from



other lands, blame is being put on the governments and institutions that hailed free trade as a saviour. The anger and resentment that has been generated are being harnessed by political movements and populist leaders who promise to give power back to the people.

Donald Trump in the US is just one manifestation of this trend. Trump and UKIP in Britain are the most successful and vivid examples of this phenomenon. Similar movements have gained strength in other liberal European countries such as the Front National in France, the Alternative für Deutschland in Germany, the Five Star movement in Italy and the Party for Freedom in Holland.



# Making America Great Again



Donald Trump ran a whole campaign for the US president on uprooting US global obligations and shifting the burden to those free riders who benefit from US expenditure, but contribute little. Trump began with pulling out of the Trans Pacific Partnership (TPP). On his first week in office President Trump signed a Presidential memorandum to withdraw the US from the TPP.

Next on Trump's list was NAFTA. The North American Free Trade Agreement was labelled "*the worst trade deal*," ever signed by the US.<sup>3</sup> Trump blamed NAFTA for wiping out US manufacturing jobs because it allowed companies to move factories to Mexico where labour is cheaper. In April 2017, Trump threatened to pull out of the trade agreement. Canada and Mexico insisted to renegotiate it instead, and Trump agreed.

NAFTA eliminated almost all tariffs among the three nations, allowing for the seamless flow of goods and supplies across borders. Today, nearly \$1.4 billion in goods cross the US-Mexico border every day. NAFTA also makes it easy for companies to move operations from the US to Mexico.

The reality is NAFTA has had mixed effects on the US labour force. Some industries have shrunk, while others have grown. The Economic Policy Institute said in 2013 that some 700,000 jobs had been lost as production moved to Mexico - with California, Texas, and Michigan among the worst hit states. A 2014 report from the Peterson Institute for International Economics said that at most 5% of US job losses could be traced to imports from Mexico. It said over four million Americans lose their jobs each year by plant shutdowns and mass layoffs, regardless of trade.

After year-long negotiations which saw the US nearly walk away from the world's largest free trade area and after Canada was nearly excluded, on 1<sup>st</sup> October 2018 the renegotiated free trade area became the 'US-Mexico-Canada Agreement'. The US and Mexico resolved an issue over automotive manufacturing, but several sticking points with Canada remained. Trump wanted Canada to open its dairy markets to US farmers, and Canada wanted to preserve a mechanism for resolving disputes. Those goals were achieved in the final deal.



# The Transatlantic Alliance

For decades, the transatlantic alliance has served as the bedrock of the liberal order, which America has presided over. However, the Trump administration was looking to jettison Europe and establish new alliances with European partners and erstwhile enemy states like Russia. This brazen attempt to ditch old alliances led to several European leaders to re-evaluate their relations with the US. At a NATO summit in July 2018, Trump made clear how he felt about the alliance, he said: “Germany, as far as I’m concerned, is captive to Russia because it’s getting so much of its energy from Russia.” Trump told NATO Secretary General Jens Stoltenberg over breakfast:

“So we’re supposed to protect Germany when they’re getting their energy from Russia? Explain that.”<sup>4</sup>

*Despite all the fiascos and chaos associated with Trump’s presidency, there is an underlying strategy to support the administration’s America first mantra.*

America in striking bilateral deals with a variety of European countries.

Despite all the fiascos and chaos associated with Trump’s presidency, there is an underlying strategy to support the administration’s America first mantra. Trump’s disdain for multilateral agreements is the first signal that America does not want to play by the rules of the liberal

order and is not concerned about the ramifications. Instead, Trump is seeking to replace multilateral agreements with bilateral ones. On his trip to Europe, he emphasised in an interview that America would only enter into a trade alliance

with the UK if Prime Minister Theresa May opted for hard Brexit—a clean break from the EU.<sup>5</sup>

Trump’s administration has openly coveted the far right across the European continent. The main aim is to forge and encourage ties with European nationalists in order to weaken and even dismember the EU in the long run. In Trump’s view, a collection of European nation states vying for supremacy is far better than the EU, and this will assist

The Trump administration is cognisant of America’s weakness and the limitations of the international system to counter the rising challenges of powers such as China and Russia. In a world transitioning from unipolarity to multi-polarity, rewriting rules is a gambit the Trump administration believes will serve America’s interest best.



## Defending the Empire: the National Defense Strategy (NDS)

In February 2018 the Pentagon published the administration's new National Defence Strategy. It articulated a shift in US strategy: great power competition, not terrorism, is now the primary focus of US national security. The reports main conclusion was: *"The central challenge to US prosperity and security is the re-emergence of long-term, strategic competition by what the National Security Strategy classifies as revisionist powers. It is increasingly clear that China and Russia want to shape a world consistent with their authoritarian model—gaining veto authority over other nations' economic, diplomatic, and security decisions. Long-term strategic competitions with China and Russia are the principal priorities for the Department, and require both increased and sustained investment, because of the magnitude of the threats they pose to US security and prosperity today, and the potential for those threats to increase in the future."* <sup>6</sup>

The Iraq and Afghan wars have dominated the US for the past two decades, not anymore according to the new NDS. China and Russia – traditional competition between nation states is now the order of the day. The Chinese response to the new strategy was that the US is stuck in a Cold War, zero-sum mindset as neither China nor Russia individually or combined have the intention or the capability to replace the US on a global scale.



*The US is not gearing up for a new Cold War but is beginning work to preserve its position without getting overstretched and bogged down in conflicts that are peripheral to its core interests.*

The neocon ambition in the 1990s of using the peace dividend afforded after the collapse of the USSR was to leverage America's hegemonic position to turn the 21st century into another American century. This gave the US the Roman Empire problem of being overstretched and this new strategy is to be able to manage and contain potential challenges across the world through more subtle tools such as America's economic power to its naval might and to its vast network of security allies and partners. Syria was the first example of this where the US did not do the heavy lifting. This, in theory, is meant to give the US the bandwidth to focus on more critical and strategic issues. The two core areas the NDS focused on was maintaining the US military's decisive technological edge and dealing with economic threats. According to Secretary of Defence James Mattis, this should take priority over expanding the size of the military.<sup>7</sup> As China and Russia cannot compete with the sheer size of America's global military capabilities they have worked to raise the cost of US interference in their respective spheres of influence beyond what the US may be willing to bear and alter the balance of power

there. With the future of warfare increasingly influenced by outer space and the cyber realms, Russian and Chinese breakthroughs in these areas would make America's sizeable conventional and geographical advantages matter less. China and Russia could due to proximity in their regions leverage these against the US and prevail. Hypersonic missiles, long-range cruise missiles, stand-off technology and secure communications technologies are the current priorities in this area.

The most striking part of the National Defence Strategy was how much the Pentagon called attention to threats – particularly economic – that it is ill-suited to do anything about. China is the main focus here. The Pentagon doesn't offer much in the way of specific solutions to this problem. This is, in part, because countering the Chinese economic ascent is not the Pentagon's job.

*The NDS recognises that the US in the past two decades, has got involved directly in too many issues and has become overstretched. China and Russia have as a result been able to play spoiler and the NDS is trying to refocus attention on what the Pentagon has identified as emerging priorities. The NDS attempted to refocus on the strategic realities that will dominate America's future.*

# The Fight for the 21st Century

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Whilst the Pentagon pointed to the economic threat posed by China but provided little in terms of policy, the Trump administration began what the Chinese called the “biggest trade war in history.”<sup>8</sup>

The US and China’s first round of talks ended on 4<sup>th</sup> May 2018 with little progress made. The trade spat, started by the Trump administration saw the US delegation, which included Treasury Secretary Steven Mnuchin and Trade Representative Robert Lighthizer, issue demands to Chinese negotiators. The demands (highlighted in the graphic below) were ridiculous. They in effect wanted China to bow down and roll over to the US.

## U.S. Economic Demands on China

They can be grouped around six key themes.

### Trade Balance

China must cut its trade surplus with the United States by \$200 billion by the end of 2020, compared to 2018 levels.

### Intellectual Property and Technology Theft

China must immediately end subsidies and support to industries in its Made in China 2025 plan, halt policies promoting technology transfer, and stop government-backed theft of intellectual property.

### Tariffs and NTBs

China must further open its economy to foreign imports and lower its tariffs to U.S. levels in all noncritical sectors. China must also remove certain non-tariff barriers in many key sectors.

### U.S. Investment Restrictions

China cannot issue challenges or retaliate if the United States places significant investment restrictions on Chinese investors in strategic sectors.

### China’s Investment Restrictions

China must make it easier for U.S. companies to invest in China and remove foreign investment restriction and ownership requirements.

### China’s Non-Market Economy Status

China must drop the vital case at the World Trade Organization challenging U.S. treatment of China as a non-market economy.





After months of threats of tariffs, on 6th July 2018, the US imposed a 25% duty on \$34bn worth of Chinese imports. In retaliation, China imposed tariffs on politically sensitive US agricultural imports. In response to the Chinese response, on 10th July 2018, the US trade representative launched a two-month process for imposing tariffs on a further \$200bn in imports from China.

Whilst negotiations continue even today between the US and China to find common ground, the underlying competition between the world's two largest economies is really about the sitting global hegemon trying to deal with the rising power. This truly is the opening battle for economic and political supremacy for the 21st century.

President Trump had promised in his election campaign to fix China's long-term abuse of the broken international system and unfair practices. Starting in January 2018 he imposed a tariff on solar panel imports, most of which were manufactured in China. On 6th July 2018, Trump imposed 25% tariffs on \$34bn of imported Chinese goods. A tariff on an additional \$16bn of Chinese imports was added in August 2018 with China responding proportionately. A further tariff on \$200bn of Chinese goods went into effect on 24th September 2018.

For the remainder of 2018 Trump threatened to add tariffs to the remaining \$200bn trade with China. In the G20 meeting in Argentina in November 2018, Trump and Xi managed to agree that China would purchase more US goods in return for the US not imposing further tariffs. The Trump administration said the original tariffs were necessary to protect the

intellectual property of US businesses, and to help reduce the US trade deficit with China.

In addition to trade tariffs, the Trump administration worked to restrict Chinese investment and acquisitions in strategic sectors such as technology; the US began cracking down on Chinese technology companies. On 16th April 2018, the US Department of Commerce reinstated an order barring US companies — including tech giants

such as Google, Qualcomm and Intel — from selling parts, software and equipment to the Shenzhen-based telecommunications giant ZTE Corp. ZTE is one of the most important companies in China's ongoing tech innovation strategy. An estimated 30% of its supplies and components come from US companies. The US is targeting the economic sectors and technologies that China's rise has depended upon.

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# *Case study: A History of US-Sino relations*

For decades the US viewed China as a paper tiger, a nation with plenty of potential but steeped in backwardness, poverty and communism. The US, with political skill, was able to lure China from the Soviet Union in the early 1970s (who China always had difficult relations with) and divide the Eastern camp. China's leadership realised by the 1970s that communism had failed to develop China and had, in fact, caused the nation colossal economic problems. Turning to the US during the Cold War Chinese leaders hoped they would get access to modern technology, skills and expertise.

During the 1990s and after the collapse of the USSR the US did not consider China a threat and considered its prospects rather bleak. The Clinton administration (1991-2001) viewed China as a partner in the post-Soviet world, especially its cheap labour, which US corporations were looking to exploit.

But this all changed when George W. Bush came to power in 2001 surrounded by the neocons who were looking to make the 21<sup>st</sup> century the American century. Condoleezza Rice wrote in an article for the Foreign Affairs magazine in 2000: *"China resents the role of the US in the Asia-Pacific region. This means that China is not a 'status quo' power but one that would like to alter Asia's balance of power in its own favour."*

*That alone makes it a strategic competitor, not the "strategic partner" the US policy makers during the Clinton era viewed the her and giving her access to some US technology. The Neocon administration faced a China whose economy had passed the \$2 trillion mark and who was scouring the world for energy and resources. This new-found wealth caused great concern in the East Asia region, especially when China began to lay claim to the region's waters, artificial islands and reefs. US policy makers viewed containment as the best way to curtail any ambitions China might have, it used the surrounding nations of South Korea, Vietnam, Japan, Taiwan and India with arms deals to contain any break out by China.*

*Clinton administration once called it." 9*

But today, containment has clearly failed. China's economy has grown 12-fold and in 2016 surpassing America's GDP. The US has been the world's largest economy every year since 1881. China is today the number one trade partner for 138 of the world's 200 nations, making it the world's largest trader. This wealth and the numerous projects China has announced means China and the US are on a collision course.



# Assessing the Sino-US Trade War

What effect will the trade war have upon China? One would think the cheap goods the US receives from China would be greatly affected in the trade war; on the other hand how dependent is China on the US market?

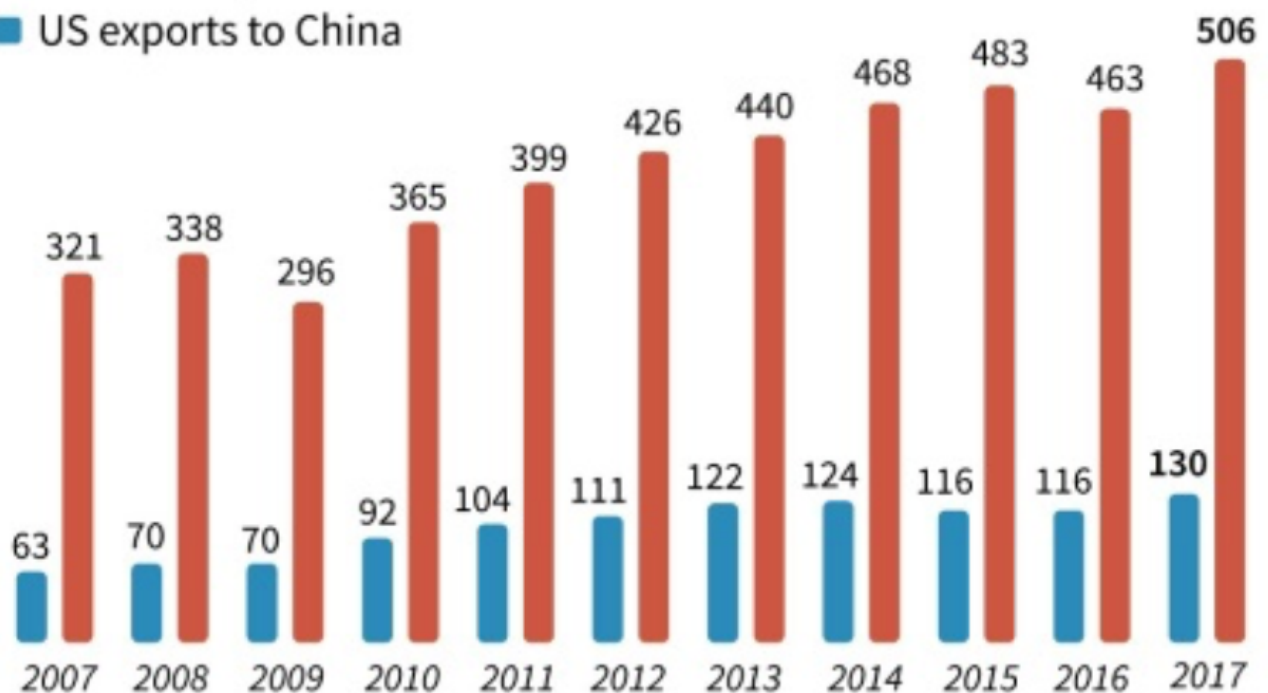
## China-US trade in goods

### Trade in goods

In billions of US dollars

■ Chinese exports to US

■ US exports to China



Unlike the other large economies, 20% of China's economy is based on exports. With the US economy, only 11% of its economy relies on exports.

The US is the largest destination for Chinese exports by far – in 2017, 23% of Chinese exports, worth roughly \$506b, ended up in the US. Then it was Hong Kong – 11%, Japan 6.6%. The US market is crucial for China, especially as exports have played a key role in China's rise. Whilst China is looking to restructure and reduce its dependency on exports, for the moment, the US market is key.

America's GDP is \$19.3 trillion; exports are \$1.3 trillion - under 10%. The US imports or China exports to the US are largely cheap consumer goods such as computers, textiles and toys. The US could produce these at home, although the supply lines for these have all moved to China. It could also get these from other destinations if needed. China, on the other hand, will not find another consumer market that consumes goods the way the US does.

For China, the US consumer market is a source for technology, dollars and economic growth. For the US, trade with China is important, from the perspective that the Chinese produce goods cheaper than anyone else in the world. In the trade between both countries, China really needs the US more than the US needs China.

*Beginning a trade war with China along with several other flashpoints shows China has come a long way from the backwater nation the US for long viewed it as. Today the US views China as a power that has the propensity to displace America's hegemony. America has struggled to contain China within the rules of the existing international system and the trade war is an ominous sign for the leading nation of the world.*



# North Korea

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Donald Trump's first year as president saw plenty of noise and bluster against North Korea. This has become an annual event as the US would move its military into the Pacific due to an imminent nuclear threat from North Korea only to back down and engage in talks. The fact that North Korea is in close proximity to China is not lost on most analysts. However, 2018 was another year no-one expected the sight of Trump and Kim Jong-un being photographed in a summit; one year is indeed a long time in politics.

North Korea was always a useful issue to justify defence expenditure and maintain a large military presence in close proximity to China. But 2018 saw a rapid change in the American position, threatening nuclear devastation in 2017, welcoming summit negotiations in 2018. So, what changed?

Throughout 2017 the US threatened war with North Korea as it tested its nuclear weapons, especially its missile tests. In September 2017 North Korea conducted its sixth nuclear test, causing a 6.3 magnitude seismic event, as measured by the US Geological Survey. This came after North Korea conducted its first successful test of an intercontinental ballistic missile (ICBM), that could theoretically reach anywhere in the world. After three decades of threatening North Korea and placing sanctions upon it, North Korea hasn't just developed a nuclear device and delivery system, but it was also improving them. Then in January 2018 and culminating in the Winter Olympics in February 2018 in South Korea, Kim Jong-un's sister visited South Korea but more importantly President Moon Jae-in began to pursue aggressive normalisation efforts with North Korea. America's aggressive behaviour and threats had not just failed, but North and South Korea were engaging in direct talks, without the US.



# *Case study: Korean Unification*

On 27 April 2018, Kim Jong-un stepped over the military demarcation line at the Demilitarised Zone, becoming the first North Korean leader to set foot in South Korea since the 1952 war. Kim and his South Korean counterpart, Moon Jae-in, then joined hands and briefly crossed back into North Korea. Their subsequent summit was the first between leaders of the North and South in more than a decade and only the third ever. Although there are many forces keeping the North and South apart, both are in agreement of when, not if, unification will take place.

For as much as Seoul and Pyongyang are fixated on the threat they pose to each other, historically, the threats to Korea have come from outside powers. Historically, the peninsula has posed a potential threat to three major powers: China, Japan and Russia, who all subjugated the Korean peninsula at some point in history.

A unified Korea would eventually be much more powerful, by most metrics, and in a much better position to shape its own destiny and put an end to its legacy of foreign subjugation. Today, the two sides have 1.75m troops, which if combined would be the world's fourth-largest army. It would no longer have to devote an inordinate amount of resources to defending the demilitarised

zone and could reorient its force posture to external defence. It could conceivably emerge as a nuclear power. The US would either lose interest in military action, and thus lose the cause for keeping US forces on the Peninsula, or it would view a unified Korea as a threat. China, Japan and Russia would face an ascendant and increasingly outward-focused regional power. Over time, reunification could also dramatically boost the peninsula's economic heft, with North Korean minerals and cheap labour flowing south, and South Korean technology, capital and food flowing north.

Today, as historically, the fate of the Korean Peninsula is not only Seoul and Pyongyang's to determine. None of the outside powers with a major interest in Korean affairs have an outright veto on reunification, but one could imagine many ways in which they could try to shape the process in their favour, if not try to thwart it outright if it moved in a direction that hurts their own interests.

It was in this light the US changed track and called for a direct summit with Kim Jong-un, which eventually took place in Singapore on the 12<sup>th</sup> June 2018. It was historic as it was the first time ever a US president and North Korea leader held direct talks. The summit ended with a joint statement with the US and North Korea committing to several key things: establishing new bilateral relations, making a joint effort to establish lasting peace on the Korean Peninsula, working toward complete denuclearisation of the Korean Peninsula and recovering the remains of US soldiers from the Korean War. Trump also offered unspecified 'security guarantees' to North Korea. Most significantly, in exchange for North Korea agreeing to 'complete denuclearisation,' the US suggested that it may ease its sanctions on North Korea prior to complete denuclearisation and that it will halt US-South Korea military exercises.

Ultimately, the top-level meeting served as a starting point and a way for lower-level officials to work out the details of the broad framework put in place by Trump and Kim. It was a victory for Trump, personally and allowed him to replace his National Security Adviser and his Secretary

of State with fellow hardliners John Bolton and Mike Pompeo.

North Korea has used the threat of tests and the tests themselves as weapons against its neighbours and the US. It has manoeuvred itself into a situation where the US, Japan, China, Russia and South Korea have to sit down with it at the negotiating table in a bid to persuade it not to build weapons. Sometimes, the great powers give North Korea money and food to persuade it not to develop weapons. It sometimes agrees to a halt, but then resumes its nuclear activities. It never completes a weapon, but it frequently threatens to test one. When it carries out such tests, it claims its tests are directed at the US and South Korea, as if the test itself were a threat.

Since the Trump-Kim summit, no tangible progress has been made. The first Trump-Kim summit follow-up visit to North Korea did not go well for the US Secretary of State Mike Pompeo. He walked away empty-handed, had no meeting with Kim and was harshly rebuked in state media by North Korea's Foreign Ministry. Further, the US asked the UN to rebuke China and Russia for alleged large transfers of oil to North Korea. North Korea has continued



to expand nuclear facilities and to develop its submarine programme. North Korea has no intention of abandoning its nuclear programme anytime soon. North Korea has now got the US into a protracted negotiation over minor, peripheral issues while stonewalling US demands for rapid unilateral denuclearisation. Since no one really wants to go to war, the US has little choice but to follow North Korea's plan.





# *Case study: Military Intervention on the Korean Peninsula*

North Korea on its own has always presented little threat to the US. Its army is outdated and has little conventional capability. The US, on the other hand, has several thousand operational nuclear missiles. It has a large fleet of strategic bombers, a large navy and hundreds of thousands of soldiers and marines. The US could bomb, blockade, and invade North Korea if it chose to incur the cost. If North Korea's possession of a nuclear device possess a threat, why doesn't the US make good on its long-term threat?

The US could use its military to conduct sites to take out the country's missiles leadership. The problem with such be certain to hit back hard, using its at America's allies: South Korea and hundreds of thousands of people — in South Korea and thousands of others were dropped. So, the US, today, America's military has huge costs and potentially catastrophic consequences.

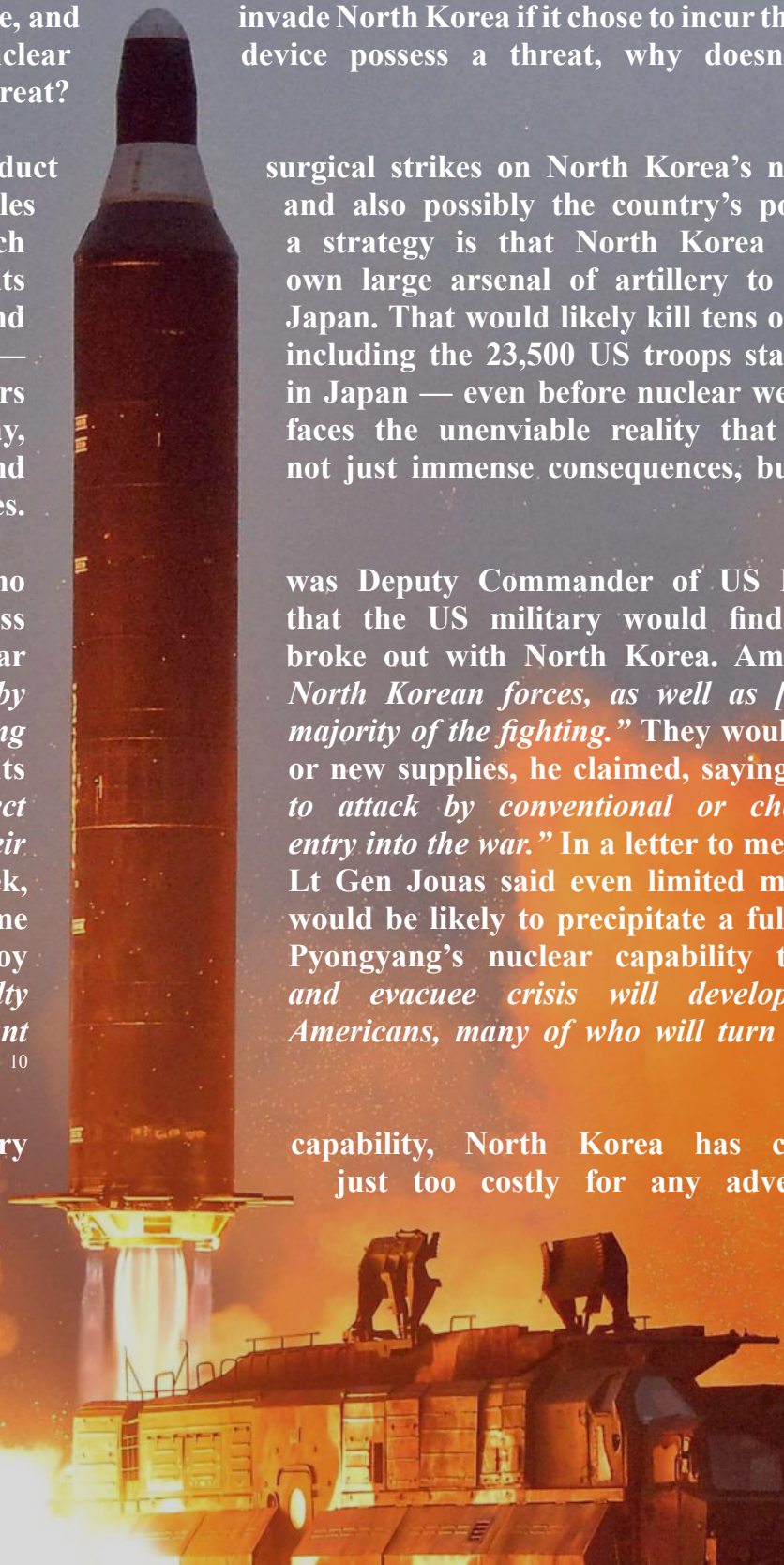
Retired Lt Gen Jan-Marc Jouas who Korea, outlined in a letter to Congress outnumbered and under-supplied if war troops *"...are vastly outnumbered by forces that will conduct the overwhelming face problems in getting reinforcements troops "may well find their bases subject weapons, which will further delay their of Congress, obtained by Newsweek, action against Kim Jong-un's regime war, yet would probably not destroy He added: "An enormous casualty include over 100,000 non-combatant forces to get them off the peninsula."*<sup>10</sup>

Despite America's military a situation where any war is

surgical strikes on North Korea's nuclear and also possibly the country's political a strategy is that North Korea would own large arsenal of artillery to strike Japan. That would likely kill tens or even including the 23,500 US troops stationed in Japan — even before nuclear weapons faces the unenviable reality that using not just immense consequences, but also

was Deputy Commander of US Forces that the US military would find itself broke out with North Korea. American *North Korean forces, as well as [allied] majority of the fighting.*" They would also or new supplies, he claimed, saying fresh *to attack by conventional or chemical entry into the war.*" In a letter to members Lt Gen Jouas said even limited military would be likely to precipitate a full-scale Pyongyang's nuclear capability totally. *and evacuee crisis will develop and Americans, many of who will turn to US*

capability, North Korea has crafted just too costly for any adversary.





# The 'Frenemy' Called Iran

On 8<sup>th</sup> May 2018, President Trump announced that the US will unilaterally withdraw from the Iran nuclear agreement, formally known as the Joint Comprehensive Plan of Action (JCPOA) and will re-impose all US sanctions previously lifted or waived as part of the JCPOA.

The discussions on the JCPOA and around it had been ongoing for a considerable length of time. They, in fact, began going back to the second term of the Bush administration when the US was drowning in the insurgency in Iraq. But it was the outbreak of the Syrian uprising that gave added impetus to the Obama administration to finalise an agreement; without the agreement of many in the Republican Party and more notably the Zionist entity - Israel.

Despite bellicose statements against the Assad regime the US in reality had no alternative mechanism to secure its strategic aims in Syria. The continuation of a secular regime in Damascus remained its focus in US strategic estimates for Syria.

When the Assad regime was teetering on the brink of collapse in 2012, the US badly needed an Iranian intervention to buttress the regime, but the reality of Iran's decrepit economy was that it could ill afford such an expensive undertaking. The JCPOA agreement released over \$150bn of funds for Iran, with the US being in such haste to ensure timely delivery of funds to Iran, it expedited delivery by taking the unprecedented

approach of airlifting \$1.7bn in cash directly to Tehran.<sup>11</sup>

Iran has facilitated and accommodated every US intervention in the Middle East and Afghanistan for the last 20 years and has in turn benefited immensely from US policies. The US invasion and subsequent occupation of Afghanistan was possible with Iran's support as it sealed its 1,200 mile border with Afghanistan to prevent weapons and logistical support reaching the Taliban. This was essential to maintain the very limited stability that US has been able to achieve in Afghanistan.<sup>12</sup>

Iran's significant role in Afghanistan is exceeded only by its considerable influence over Shi'ah militias in Iraq, whose co-opting into the US crafted political architecture turned the tide and prevented an embarrassing defeat for the US in Iraq.<sup>13</sup> The role Iran played in the US war against ISIS brings to the fore the relationship between the US and Iran. Although many theories exist why 30,000 heavily armed Iraqi troops deserted in the face, against less than 800 lightly armed ISIS fighters in Mosul: it is no secret that Iranian trained and sponsored militias halted and eventually reversed ISIS gains; with unprecedented co-ordination between them and US airpower.<sup>14</sup>

The war against ISIS and the Iranian involvement in Syria has bolstered the Iranian position in the region. Syria is virtually an Iranian vassal state, Iran's proxy Hezbollah and its allies command a healthy majority in the Parliament in Lebanon and Iranian militias have successfully translated their military victories into a genuine political clout in Iraq. Iranian influence now extends from



the subcontinent, through the Persian Gulf to the Mediterranean Sea, and mirrors the largest westward extent of the Sassanid Empire two millennia ago.

This is completely at odds with the agenda the US had with Iran, it was looking to use it to achieve some of the details of its grand strategy in the Middle East but Iran has in turn used the opportunity to embed and strengthen itself in the region. Not just that, it's actually expanded in the region.

The clerical regime in Tehran made the grave mistake and considered Washington's reliance on it in Syria and Iraq as an indication of Iranian power. The fact that the US has been able to realise its strategic interests through Iran, without deploying considerable numbers of its own troops in wars which would damage its credibility as a world leader, shows the immense power and influence that the US wields in the region. It is power and influence that the US is not willing to share with anyone in the region despite the occasional cooperation. With the Syrian regime no longer in danger of collapse and the comprehensive defeat of ISIS and the general Sunni resistance in Iraq all but finished: it is only natural that the US moves to demarcate and limit the extent of Iranian expansionism and influence. Iran's clerical regime is learning, the hard way, again, that the US works with Iran from time-to-time to preserve its influence not to share the region with Iran.

*Although the relationship between Iran and the US may seem acrimonious, cooperation and coordination between them as has been a regular feature for almost three decades.*



# Conclusions

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President Trump shows us once again that there is a vast divergence between the rhetoric of politicians and American reality. Trump, like many of his predecessors spoke about retrenchment and ending US global entanglements, but this does not mean the US is going into isolation. It is merely recalibrating how it will remain the hegemon as its overstretched empire is a costly business.

Since America's first forays abroad it utilised different styles and means to achieve its goals. The key aspect of these styles and means is that they are temporary; they are not designed to be permanent. The US supported the Mujahideen in Afghanistan against the Soviet Union with finance, arms and training, who would go on to form the Taliban. Today they are an enemy to be fought. The global liberal order served the US well, but it was only temporary to achieve and institutionalise US goals.

All of this shows us that the US develops plans and strengthens them with a whole host of tools in order to make them effective. Despite the global balance of power changing, the US is adapting to this new reality by abandoning old strategies and developing new ones. The US faces new challenges and is not the nation it was prior to the Iraq and Afghan wars but is working to maintain its global position with the resources it has. Thus, it has not abandoned its role in the world, despite the challenges it faces at both home and abroad. This is why the US remains the world's superpower in 2018 and it's why no other nation is in this position instead of the US.

As global power is always in a flux, it remains to be seen if the US can continue to develop plans to deal with the differing challenges it faces, but much of this depends upon what the other nations can do to the US in the different regions of the world.

## 2019

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### **The problems of Empire:**

The US now faces the problem all empires do of having to be present in all places at the same time to maintain what it has colonised. Like the empires before it, the US uses its military, with a high readiness rate around the world to maintain its position. This all costs money, money that cannot then be used to fund education, infrastructure or health. Domestic taxes are insufficient to fund this so the US resorts to debt, which has created a \$22 trillion debt bubble! The Afghan war was meant to remove a ragtag, 7<sup>th</sup> century militia force; it is now an open ended battle with no end in sight. Its sole justification is now to maintain credibility rather than achieve any strategic ends. The US is living beyond its means; it is facing regional challenges across the world, which will stretch it. In 2019 and beyond this empire-ending problem will have to be tackled.

### **New Arms Race:**

The US is in an undeclared arms race with China. The location of this arms race is in the South China Sea's and the race is being driven in the realm of naval power, with the US effort to maintain naval primacy in Asia. China is looking to upend the US using both conventional and asymmetric weaponry. This arms race is still of a modest scale by Cold War standards but all US defence establishments, think tanks and thinkers believe China's rapid naval development means it can challenge US supremacy in its home waters. This is a unique moment, as since WW2 no nation, even in its home waters could challenge America's sea supremacy. In 2018 China surpassed the US in the number of vessels in its navy, the US is no longer the world's largest navy. For the US, even a loss of one region is a reduction in US power, in 2019 and beyond, the US will have to deal with this potential game changer.

### **The Future of US Alliances and Partnerships:**

The Trump administration's policies are harming the alliances and friendships, the US carefully developed over the decades, and has been one of its greatest assets over the last 70 years. Trumps 'America first' mantra has left a vacuum which China is quickly filling. For the nations of the world, the US is no longer the power it was prior to the Iraq and Afghanistan wars and with the US pulling out of multilateral organisations, China really does appear to be the more reliable partner, with huge spending power. Trump may truly be destroying the US, in order to save it.



# China

*The US has made the first move in what is likely to be an escalating war to halt the rise of China. China is at a critical phase of its development where it's attempting to shift between economic models and go up the technology ladder. It also faces demographic challenges as its population gets older before it gets richer. The US has fired the first bullet, China will now need to utilise its resources like it has never before.*

# Thucydides Trap

The US sanctions against China are being described as the battle for the 21<sup>st</sup> century. As China's economic power increases it has to respond to the global hegemon who is looking to pull the carpet from underneath China's aspirations. Previously the US has accused China of currency manipulation and other anti-trade related practices, but Chinese officials were able to deflect these as the US never went ahead with retaliatory measures. As this has now changed China has been forced to respond.

China has responded to all tariff announcements by the US by imposing similar measures on US imports into China. As well as the July 2018 tariffs, the Trump administration imposed an additional \$16bn tariffs on Chinese imports in August 2018. China responded with the same action as the US and imposed its own tariffs on US imports. A further tariff on \$200bn of Chinese goods went into effect on September 2018 to which China responded with tariffs on \$60bn of US goods.

The problem China faced compared to the US was it ran out of American products to target. Americans bought \$375bn more in goods from China than the Chinese bought from the US in 2017, which meant Trump had a lot more to punish.

China was beyond the point of tariff reciprocity, but it had many alternative options it could pursue. It could dump US treasury bonds, increase regulatory pressure or impose investment restrictions on US companies in China. But China considered it more prudent to

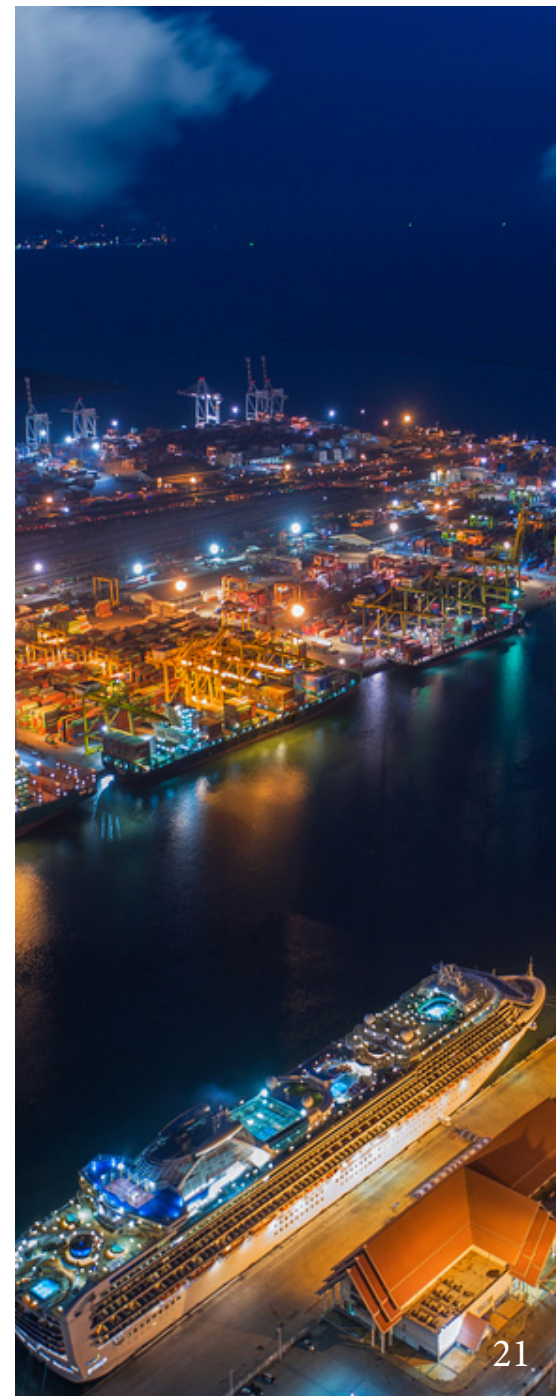
moderate, rather than escalate, its retaliatory measures, particularly when it came to strategic sectors where it needs the US and foreign investment, like the technology, auto and the energy sectors. China even moved forward in offering market access to key companies such as US vehicle manufacturer Tesla, Swiss investment bank UBS and German-based chemical producer BASF, in part to fulfil earlier promises.

Fan Gang, an economist, influential Chinese government adviser and former member of the People's Bank of China's Monetary Policy Committee, speaking at Tsinghua University on 17<sup>th</sup> October 2018, argued Beijing must not launch retaliatory attacks against US businesses in China. He said this strategy would only lead President Trump to reinforce the pressure campaign against the country and that Beijing needs to maintain its connections with US businesses since those relationships now offers "*the only voice*" that can speak for China.<sup>15</sup>

Alienating US businesses would cause China to "*really lose the trade war*". He also warned against dumping US Treasury bonds, as that would hurt China more than it would the US. Finally, he also asserted that simply agreeing to purchase more US goods is not going to ease economic frictions with the US. Fan said he wants Beijing to view the trade war with the US as a long-term strategic competition in which the US is trying to slow China's rise.

As regime insider, Fan is well

placed to articulate China's options, but it is revealing that a regime insider views the trade war as a wider strategic battle to stop China's rise. By the end of 2018, China responded with equivalent tariffs on US imports but it will need to resort to other options as clearly tariffs on US goods is not hurting the US. China needs to retaliate in other ways where it has leverage, but these will all have their own implications.



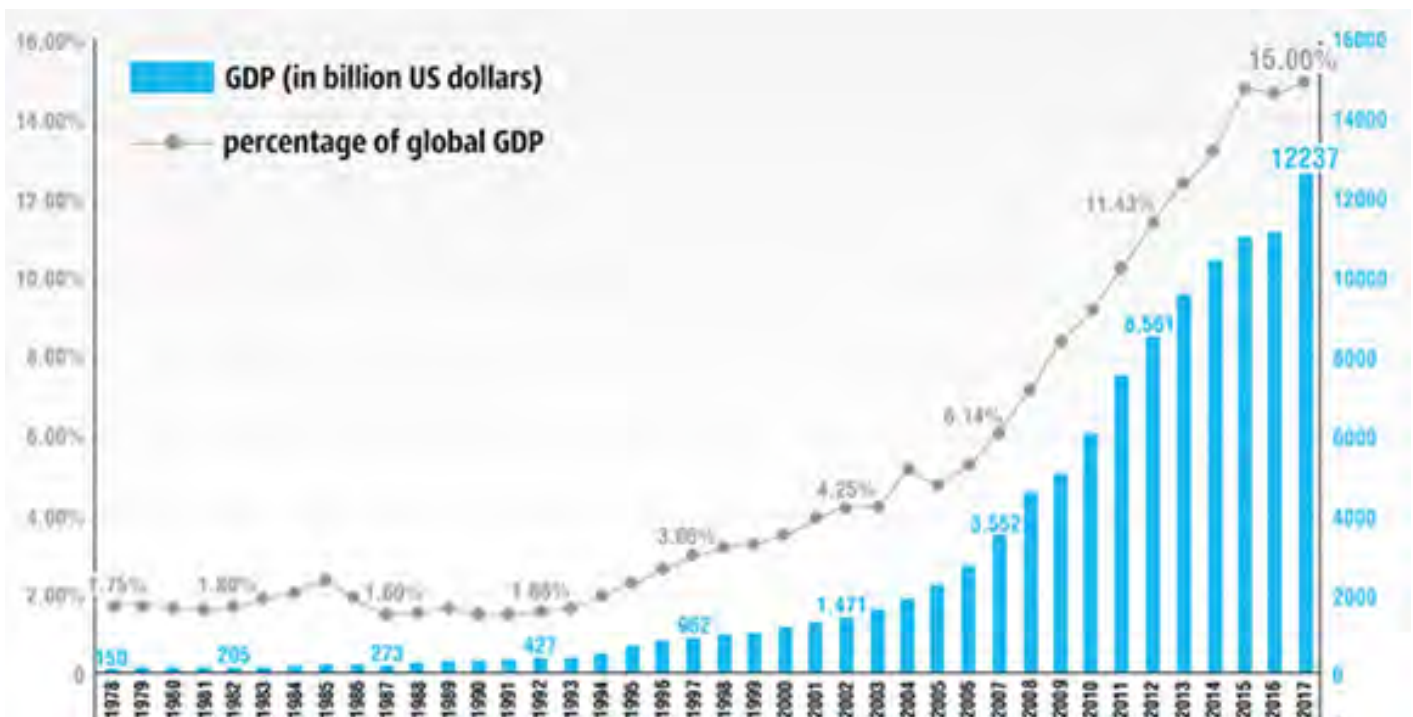


# Rebalancing China

The year 2019 will be the 40<sup>th</sup> anniversary of when China launched its “reform and opening up” policy

*By all metrics, China’s economic “miracle” has been nothing short of a colossal success. In just two generations around 800 million people are believed to have risen out of poverty and an agricultural nation converted into a giant of the global economy.*

The creation of Special Economic Zones (SEZ), attracted foreign companies to shift their manufacturing to China, alongside massive state investment and aggressive exports, this is how China managed to go from a GDP of a mere \$178bn in 1979 (Spain and Holland had larger GDPs) to today’s \$12.2 trillion. Exports came to drive nearly 40% of China’s economy. The 2008 global financial crisis showed this model of relying upon the world to consume China’s production of epic proportions has run its course and a more reliable and sustainable driving engine for the economy was now needed



In 2009, exports plunged by 16%, or \$230bn, and around ten million people along China’s coastal economic belt lost their jobs. With no driving engine to replace exports Beijing implemented monetary and fiscal stimulus measures. This decision further increased the country’s huge investment expenditures, which already accounted for 50% of China’s GDP. Whilst a large stimulus was injected into the economy, this was never going to be permanent and a restructuring was always going to be needed. China needed to make the leap many of its neighbours did long ago, to a more stable model based on domestic consumption.

Central to this is the “Made in China 2025” state-led industrial plan which will attempt to leapfrog the US as a technological innovator in the industries that will matter most over the coming century, such as robotics, semiconductors, artificial intelligence, aerospace, green energy and biotech. Made in China 2025 is being executed primarily through Chinese state owned enterprises (SOE). For the moment Beijing has relied heavily on technology transfers from Western firms including industrial espionage for its progress on tech development.



reform era began in 1979, but it took China's GDP until 1998 to reach \$1 trillion. It was the 2000s that saw China's GDP grow exponentially and this was all driven by exports and government investment. This period also saw the shrinking of consumption.

Exports leave the country and so are dependent upon the world's demand for China's goods, whilst government investment doesn't rely upon domestic consumption.

Since initiating market reforms in 1979, China has apparently lifted more than 800m people out of poverty, this would make the transition to a consumption-based economy, straightforward as 61% of the population has moved from poverty into affluence. The problem with the definition of poverty, which is usually based on the World Bank's definition, is it is extremely narrow and the 800m figure obscures, rather than reveals, that poverty is still a significant problem in China.

The World Bank began tracking poverty in China in 1981. In that year, 88% of China's population lived on less than \$1.90 a day (870m people). But if this threshold is pushed up just a little bit, poverty in China was even more striking: 99% of China's population lived on less than \$3.20 a day (over 980m people). The last year for which the World Bank has official data is 2013, and at that point, only 11% (almost 150m people) lived on less than \$1.90 a day. But 27% (almost 360m people) lived on less than \$3.20 a day. If we push the poverty rate up to \$10 a day, then 908m Chinese – 68% of the population is below the poverty line.

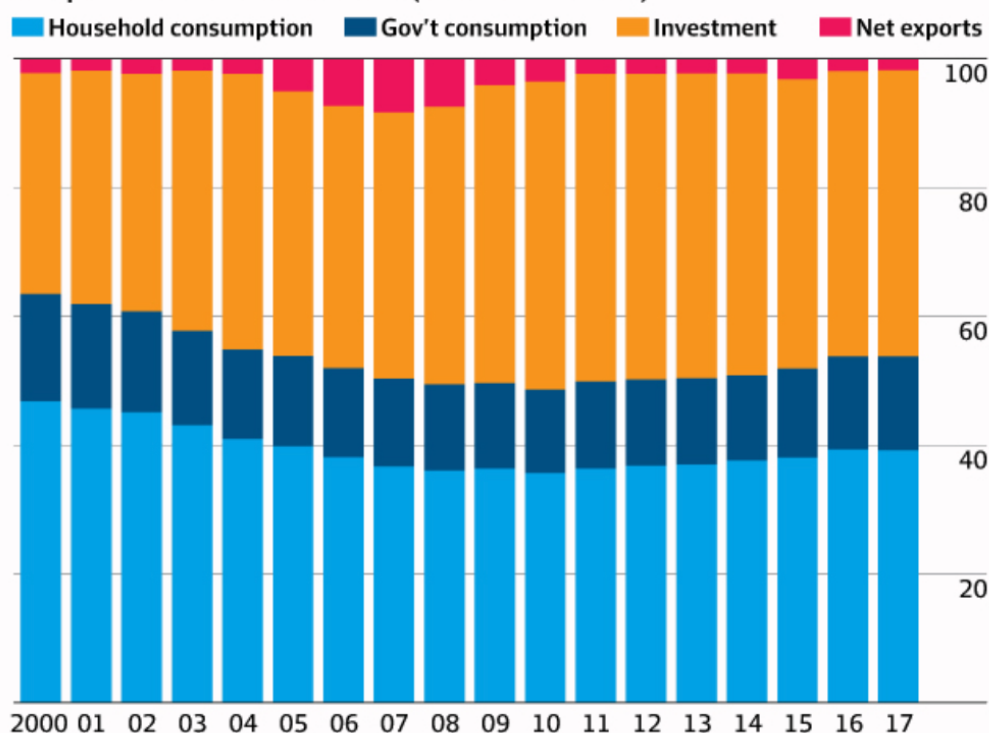
In 2018 China has made some progress in rebalancing its economy, which is crucial considering it is effectively in economic war with the US. In 2008, on the eve of the global economic crisis exports accounted for 38% of the economy, whereas today, that number has been nearly halved. Domestic consumption has become a more important growth engine in China than investment and exports combined. Meanwhile, the country's services industry — comprising sectors as varied as finance, e-commerce and logistics — is booming, now around 45% of total employment. That is nearly double the 23% that it accounted for a decade ago. Export-related employment is estimated to have dropped from 9% of total employment in 2008 to 6% today.

But these numbers do not give the full picture, China faces significant challenges in making domestic consumption the economic driving engine of the economy.

Domestic consumption was a large contributor to GDP ever since China's open and

## Rebalancing to consumption

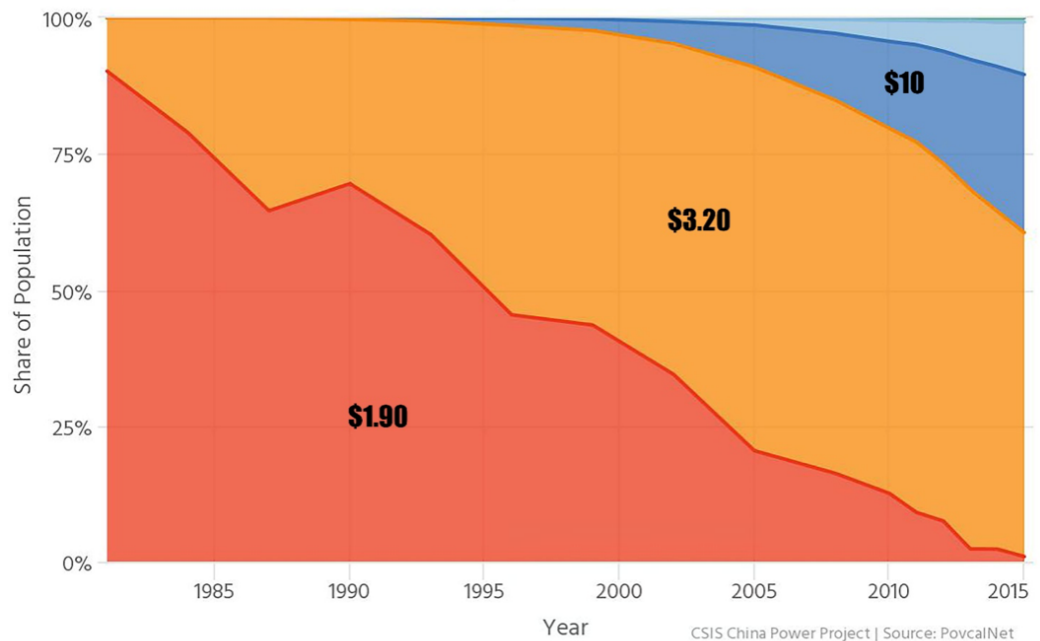
Composition of China's demand (% of nominal GDP)



If population growth is factored in, it can be claimed that China has lifted 800m people out of poverty; if poverty is defined as living on less than \$1.90 or \$3.20 a day. This doesn't say anything about how well those *lifted out* of poverty are doing. A rural household living on \$1.91 a day by this standard wouldn't be counted as suffering from extreme poverty, even though by any objective measure a household earning that much on an annual basis would be cripplingly poor.

China still faces further issues in rebalancing. The revolution in China was carried out by a massive agricultural peasant class. In 1978, only about 23% of people employed in China were urban workers – the country was still predominantly rural. As of 2015, over half of China's 770m employed workers were urban workers. The problem is that the other half – almost 380m people – are employed in rural areas. The urban households are not exactly *raking it in*, but the rural households have not progressed far enough to be able to contribute towards national consumption.

Then the division between the coastal and interior



provinces skews China's wealth situation. An urban household in Beijing and in Shanghai live a lifestyle very different from a household in Qinghai or Gansu. China's advancement has not been enjoyed evenly. Urban households in the interior Chinese provinces are earning far less than the per capita average. If that was not a problem, China's wealth distribution, this is the wealth the country's economic miracle generated, is skewed; worse than the US.

A mere 10% of the Chinese population owns 68% of the nation's wealth.<sup>16</sup> The Communist Party has a large patronage network and as a result, a large chunk of China's population has not shared in the country's economic miracle. This is why government spending has played such a crucial role as it has literally driven the country at the expense of the domestic population consuming.

The central government has spent hundreds of billions on infrastructure development, on State Owned Enterprises (SOE) and upon ghost towns creating a real estate bubble in order to stave off a downturn in 2008 when exports plummeted. The effect of government investments has been an increase of production capacity and supply, which has resulted in severe overcapacity. In addition, to ward off mass unemployment and to gain export advantages, labour costs have been reduced again, thus keeping working people's purchasing power down.





# The Belt and Road Initiative: 5 Years on

The Chinese economy depends on the sea routes for its exports and it also relies upon them for its own colossal energy and mineral needs. This growing dependency means any disruption will affect its economy and society and having a military that can protect these supply lines is essential. But China does not possess a military capability of global scale and will not do so for generations. Finding alternative routes to the sea chokepoints has been something China's officials long realised and gave rise to its "One Belt, One Road" (OBOR) initiative of reviving the ancient Silk Road (aka. Silk Route). In 2013 Xi Jinping launched the initiative and now the Belt and Road Initiative (BRI) is 5 years old.

## Belt and Road Initiative: Partial Map



Source: Economist.com

China has spent at least \$34bn on the BRI, which has gone mainly to connectivity projects such as railways, ports, energy pipelines and grids. Progress has been made but several delays and setbacks have also been experienced. The sheer scale of the BRI and the many large projects it encompasses, hold-ups and cancellations were to be expected. Some delays are due to increased scepticism and resistance to China's strategic aims have also grown, especially from the US.

Whilst China defines the BRI as a Eurasian integration project, it has for the moment focused on the developing world, particularly countries in Central and Eastern Europe, South and Southeast Asia and Central Asia. It has achieved only limited success drawing developed states, such as Japan, and developed European powers into the BRI.

China's strategy of becoming a global power is based upon integration into the developing world, especially those in strategic positions. The developing world itself has been extremely welcoming to the BRI, many of these countries - 11 of which have been identified by the UN as the world's least developed, such as Laos, Tanzania and Djibouti — have major infrastructure deficits but are eager to avoid the kind of restrictive, strings-attached financing offered by Western institutions.



Since China's approach to funding emphasises non-interference and is generally unconditional and indiscriminate of the regime, Beijing has achieved more access and goodwill than is usually given to its Western competitors.

As the BRI took shape and much of its details are now becoming public, China's approach to debt financing in key strategic projects has also led to pushback. The East Coast Rail Link in Malaysia and the deep-water Kyaukpyu port in southern Myanmar are currently under review by the recipient governments, which are already critical of China's goal of securing supply routes other than the Strait of Malacca.

Both Sri Lanka and Pakistan governments struggling with debt repayment and financing negotiations and have entered into "debt-for-assets" land-lease agreements with Chinese companies. In Sri Lanka, the Hambantota Port is now leased for 99 years, while areas around the Gwadar Port in Pakistan are leased for 43 years. In other states that already have high external debt or rely excessively on direct Chinese investment — such as Djibouti, Laos, Tajikistan, Kyrgyzstan and Montenegro — Beijing has used different forms of debt relief or forgiveness measures, in some cases resorting to acquiring the recipient country's natural resources or long-term oil contracts to offset the loans.

Despite setbacks, China's BRI is taking shape and it has even inadvertently encouraged loose regional blocs to counter it. Japan and India, for instance, have begun working on an alternative to the BRI on the African continent, participating in a US-led proposal to establish a quadrilateral framework for infrastructure investment. Elsewhere, Australia is pledging an extensive campaign of aid, trade and diplomacy in the South Pacific, hoping to regain the position it has lost to China in its traditional backyard.

Given above mentioned attempts, none of these countries' proposals can outdo China's enormous and well-funded infrastructure plan. They lack China's capital, human resources and flexibility. For participating countries, the long-term benefits of Chinese investment and infrastructure construction in many ways outweigh the risks. So, while investors should be aware that China will continue to experience setbacks in its Belt and Road projects, the initiative as a whole is still moving along relatively successfully.





# Case study: US Turns on China's BRI

Despite its status as a Pacific power, the US has been somewhat peripheral to China's BRI since the latter's inception in 2013. The US does not host BRI investments and, like many other major countries, has not signed a formal cooperation agreement setting out terms and conditions for a US role in the BRI, even though some US firms have participated on an individual basis.

The US responses to the BRI under the Obama administration and initially under the Trump administration were benign and even positive at times. This was not so much a function of US enthusiasm for China's initiative but a result of bilateral cooperation in other areas. Since mid-2017, however, senior US officials have been far more critical of the BRI. Washington has begun to explore ways to promote alternatives to Chinese financing by proposing reforms to the US development finance system and coordinating with allies and partners.

From Xi Jinping's earliest articulation of the BRI (then known as "One Belt, One Road") in 2013 until mid-2017, US official responses were largely benign. The Obama administration was well known for its rejection of China's invitation to become a founding member of the Asian Infrastructure Investment Bank (AIIB), which helps fund BRI projects, and its calls for other states to exercise caution. Nevertheless, Obama ultimately dialled back his rhetoric on the AIIB, arriving at the equivocal position that the bank "could be a positive thing," since it could contribute to regional growth, but "if it's not run well, could be a negative thing."<sup>17</sup>

Obama never fully critiqued the BRI itself or developed a specific alternative, he even offered some positive, though general, words of praise, remarking that "*Asia needs infrastructure... so to the extent that China wants to put capital into development projects around the region, that's a good thing.*"<sup>18</sup> During Xi's September 2015 visit to Washington, a White House factsheet on bilateral economic relations similarly stated that the US

"welcomes China's growing contributions to financing development and infrastructure in Asia and beyond."<sup>19</sup>

In early months of the Trump administration they placed the BRI behind other, more pressing bilateral issues. Far more important was addressing the North Korean nuclear issue, on which Trump sought to elicit Xi's support, and correcting bilateral trade imbalances, which was a persistent message of his presidential campaign.

The Trump administration's early positive rhetoric on the BRI was quickly overtaken by more negative, hostile messaging. Most notable were comments by US Secretary of State Rex Tillerson, who argued in an October 2017 speech that Chinese development, finance and infrastructure projects were producing numerous problems for recipients, including failing to promote jobs "*for the people they claim to help,*" burdening poor states with "*enormous levels of debt,*" relying too heavily on foreign (i.e. Chinese) workers, and including provisions that result in "*default and the conversion of debt to equity.*"<sup>20</sup>

During a visit to Beijing in November 2017, Trump did not mention or endorse the BRI despite the topic having been raised by Xi. Later, in a speech to officials and business leaders in Vietnam, Trump implicitly critiqued the BRI by contrasting US investments with "*state-directed initiatives that come with many strings attached.*" Complementing its critique of China's practices, the Trump team also outlined a number of interlocking efforts to provide alternative development finance sources for the region. US official perspectives on the BRI pivoted from ambivalence, with some positive overtones, during the Obama and early Trump administrations, to a more critical approach by the end of Trump's first year in office. Over the next few years, the likeliest outcome is a continuation of the current US approach of providing alternatives and confronting China. Stronger US opposition will likely involve financial support for a competing infrastructure development scheme, perhaps organised under the Quad framework.





# China's Espionage Efforts

On 10<sup>th</sup> October 2018, Belgium extradited a Chinese intelligence officer to the US after an Ohio court had indicted the operative on charges of “economic espionage involving theft of trade secrets from leading US aviation companies.” Belgian authorities arrested Xu Yanjun, a deputy division director of the Sixth Bureau of China’s Ministry of State Security (MSS) in Jiangsu, on 1<sup>st</sup> April 2018 in Brussels, based on an arrest warrant issued in connection with a US criminal complaint. American authorities unsealed the indictment and the initial criminal complaint and the case has revealed a great deal and has given a rare glimpse into China’s industrial espionage efforts.

Why is China going to extreme lengths in espionage?

For China espionage is central to its political-economic-military rise. China has long worked to obtain the technologies it believes it needs to achieve commercial and military parity with the West. This desire was formally spelt out in the *863 Program* in 1986 and more recently, a ten year plan released in 2015 called *Made in China 2025*, which publicly listed the technologies that the Chinese government has identified as critical for the future development of its economy and national strength. These cutting-edge technologies include aerospace and aviation equipment, new materials, next-generation information technology, high-end machinery control and robotics, maritime engineering equipment and high-tech maritime vessel manufacturing, advanced rail equipment, energy-saving and new-vehicle technology,

electrical equipment, biomedicine and high-tech medical devices and agricultural technology. While Beijing funds research to develop these technologies indigenously, China has found that it is often cheaper and quicker to simply steal what it needs.

For years, the Chinese have been engaged in a sophisticated industrial espionage programme targeting key technologies and intellectual property to enhance commercial enterprises and support domestic champions. Randall Coleman, Assistant Director of the FBI’s Counterintelligence Division, observed in 2015 that espionage caseloads are up 53% and that in an FBI survey of 165 companies, 95% of those companies cite China as the perpetrator. *“China’s intelligence services are as aggressive now as they’ve ever been” underscoring the pervasive nature of intellectual property and trade secret theft.*”<sup>21</sup> The FBI reports that China pays Chinese nationals to seek employment in targeted US technology firms where there is sensitive technology that China identifies it needs where they become “insiders” and more readily exfiltrate valuable intellectual property. Convictions of Chinese nationals and naturalised citizens for industrial espionage are also on the rise.

China’s cyber capabilities are among the strongest in the world probably only exceeded by Russia and the US. Cyber theft is an ideal tool for China given the asymmetric vulnerability of the US given how much information is digitally accessible and the plausible deniability given the

difficulty of attribution in cyber-attacks. The last three months has seen several documented high-profile cyber theft incidents. Former NSA Director General Keith Alexander told Congress back in 2012, this represents the *“greatest transfer of wealth in history.”* At that time, it was estimated that US companies lose \$250bn per year through intellectual property theft and another \$114bn due to cybercrime, totalling \$338bn of impact each year. *“That’s our future disappearing in front of us,”* warned General Alexander.<sup>22</sup>

What really distinguishes China from other nation-state actors in cyber-attacks is the sheer scale of activity as China dedicates a massive amount of manpower to its global cyber activities. China deploys between 250,000 and 300,000 soldiers in the People’s Liberation Army (PLA) dedicated to cyber espionage. Within another part of the armed forces, PLA has between 30,000 and 50,000 human spies working on insider operations. China’s cyber activity is not solely focused on a national security agenda. In fact, much of this activity can be deployed to support China’s economic goals in stealing valuable intellectual property to support China’s technology transfer.

The US is now hitting back against China’s efforts to acquire US technology. It has banned US companies from any joint ventures with ZTE and banned Huawei mobile handsets in the US. These actions have not deterred China and it is likely the Cold War between both nations will continue. For China it’s essential its espionage efforts yield results.

# China's Navy attempts to close gap on the US



On 18<sup>th</sup> May 2018, China's second aircraft carrier and first domestically built carrier completed its initial sea trials. It uses a conventional propulsion system, an old-fashioned short take-off but arrested recovery launching system and has limited flight deck storage. But despite this the construction of the aircraft carrier represents a significant milestone in China's steady rise as a naval power; on this trajectory, Beijing will continue its ascent. The New York Times highlighted: *"Last year, the Chinese Navy became the world's largest, with more warships and submarines than the United States, and it continues to build new ships at a stunning rate."* <sup>23</sup>

What makes China's naval development so important is the challenges it will face: it is having to develop from a very low level, to begin with. In China's history, its geography on the east of the Asian continent meant it faced invasion from land forces from the north, this was where the Mongols invaded from. It also faced invasion from the west from Central Asia from Imperial Russia. When the European imperialists arrived in the 19<sup>th</sup> century from the oceans in the South China Sea, China was forced to give Hong Kong to the British Empire in tribute. China had no navy to talk about as it was doctrinally geared towards a land invasion from one of its land borders. During the period of Mao's rule the PLA was oriented towards a protracted war which was based on the premise of a Soviet invasion of China. China's armed forces were geared fully around a massive land force, with the navy and air force having a secondary role.

The 1990s witnessed the collapse of the Soviet Union and the first Gulf War. The result of the 1991 war between the US and Iraq led to a major rethink in Chinese military doctrine. China's forces lagged far behind most of the world in military development and were utilising platforms developed in the 1950s. The annihilation of the Iraqi army, which was similarly equipped and followed a similar doctrine to the Chinese military proved to Chinese leaders that a major rethink was needed.

As China's economy grew immensely in the 2000s, this was all predicated upon its huge export machine shipping goods around the world. It was here the modernisation of its navy has become all the more important as China relies on the sea lines of communications (SLOC) to secure the country's global network of energy resources and trading activities. China needs to protect the global shipping lanes and any threat to the many islands around the South China Sea, as its economy literally depends on it. It is from this perspective China's navy is mission critical, even though well into the 1990s it was the weakest branch of its armed forces.<sup>29</sup>



Until the 1990s China's navy was barely a coastal defence force with little ability to challenge anyone. But since then China has attempted to modernise and build its navy using an evolutionary rather than revolutionary approach. Beijing carefully and incrementally introduced new designs and equipment into the navy before proceeding to intensified shipbuilding.

At the beginning of the 21<sup>st</sup> century Beijing began producing new indigenous vessels, but many of the initial designs, such as the Type 051C destroyer, depended heavily on Russian and other foreign technology for their main armaments. At the same time, China continued to purchase Russian warships, such as Sovremenny-class destroyers and Kilo-class submarines, as a hedge against the potential failure of their new designs.

In the first decade of the 2000s China constructed small batches of each warship type; only after engaging in comprehensive testing for each type did the country slowly transition to improved designs. This decade of cautious experimentation gave the country's navy the confidence to settle on reliable models for high-rate production. Chinese shipyards rapidly rolled out the Type 054A frigate, the Type 039A submarine, the Type 052D destroyer and the Type 056 corvette, making the four classes of vessel the mainstay of the naval inventory. This production did increase the size of China's fleet and replaced ageing and obsolete vessels that had remained in the naval inventory for decades.

China has increased the number of modern destroyers, frigates, corvettes and diesel-electric submarines. The navy has ambitious plans to develop new capabilities, but doing so takes at least one or two generations. This is based on no major disruptions or pauses in the process. For the moment China does not possess a navy that can be at sea for long periods, far from its coast, conduct operations and achieve

*For the moment China does not possess a navy that can be at sea for long periods, far from its coast, conduct operations and achieve maintenance and all the complex logistics that comes with it. This is because China's navy still consists largely of smaller ships with low tonnage. Although it does have many of these ships, even more than the US.*

logistics that comes with it. This is because China's navy still consists largely of smaller ships with low tonnage. Although it does have many of these ships, even more than the US. The US on the other hand has larger vessels which give it more firepower and more bang for its buck. Its 11 aircraft carriers carry three air squadrons on a continued basis around the world. Although China has made much progress, it is nowhere close to US capabilities and remains a regional force, despite some operations further from home.

Over the next ten years, China will construct next-generation nuclear submarines that emit far less sound, build new types of aircraft carriers equipped with catapult launch systems and expand its amphibious fleet with the introduction of Type 075-class amphibious assault ships. Supplementing the addition of this hardware will be a continued focus on the country's logistics fleet, which is key to conducting blue-water operations — sustained, long-range maritime operations over oceans and deep waters — and securing logistics bases around the globe.

# Conclusions

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China has made progress in 2018 to build its capabilities, but it now has the global hegemon focussing on it as it views the country as a threat to its position within the Asia-Pacific. China's economy has been central to its rise and it has begun to make the transition to moving away from an export driven economy, but it faces significant challenges in converting to a consumption-based economy.

In 2018 China launched the first petro-yuan contract, being the world's largest consumer of oil makes this long overdue and this does in the long run represent a challenge to US dollar dominance. If China could get the Gulf States and Saudi Arabia to use the yuan in oil trade, then 2018 would indeed be a significant year.

China is working to keep its trajectory going as it will need all its domestic strength to pose any challenge to the US. Despite the BRI, China remains for the moment a regional challenge for the global superpower, until it breaks out of its region or begins manoeuvring politically around the world it will struggle to weaken the global hegemon.



## 2019

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### **Global Power:**

China has yet to outline what its agenda is for the world. This is mainly because China currently lacks global ambitions. Whilst China has been making economic deals across the world, how the world should look and what China plans for the world is markedly missing. In 2019 and beyond China needs to show the world it has global ambitions and highlight what the world should look like. This will show China indeed has a global outlook and not the current regional one.

### **Naval Power:**

Despite impressive development in its navy China remains a largely local force. Whilst China is focussing on overland routes for its economy, over 90% of trade and energy traverses the oceans and China lacks a global navy to protect these supply lines. Currently China relies upon naval bases and cannot travel too far from them as its ships are small and limited in range. Nuclear propulsion will help this, but for the moment China's navy is limited in what it can achieve due to these limitations. In 2019 and beyond China will need to overcome this if it wants to be a player on the global stage.





# Russia

*Russia has continued to engage in issues around the world from Syria, Ukraine and Afghanistan. Many consider Russia to be taking over from the US in the Middle East. But 2018 has seen various underlying trends catch up with Russia from its economy to defence failures. Russia has been shouting much louder than it is capable of and 2018 shows Russia faces significant challenges in challenging the global superpower.*

# Putin Re-Elected, but Trouble Lies Ahead

Vladimir Putin was re-elected as president of Russia, for his second consecutive (fourth overall) term in office with 77% of the vote on a voter turnout of 67%. Despite allegations of irregularities and criticisms of the 18<sup>th</sup> March 2018 election, Putin achieved what he set out to achieve: a mandate for the next six years. Putin can remain in office through to 2024, which would make him the longest-serving Russian leader since Josef Stalin.

On the day of the election, Putin had been in power for 18 years. He has been able to rebuild some of the country's former empire out of the wreckage of the Soviet Union. This has taken time, but he now faces a very different set of circumstances that threaten his legacy and the future stability of Russia.

Vladimir Putin is a former KGB agent who rose to power after the USSR collapsed and the messy 1990s under Boris Yeltsin. He was from the security class and was backed by the Federal Security Services (the KGB's successor) and his own network he developed throughout the 1990s in St. Petersburg. When Putin officially took power in 2000, he inherited a divided country plagued by a broken economy and different regions looking to secede and bloodied by the war in the Caucasus. Putin spent his first and second terms in office on containing and reversing the anarchy. Putin dismantled regional dissent, cracked down on the oligarchs, nationalised strategic assets, weeded out political challenges and rallied nationalism. By establishing an authoritarian system, Putin micromanaged and mediated the consolidation of the country under his rule.

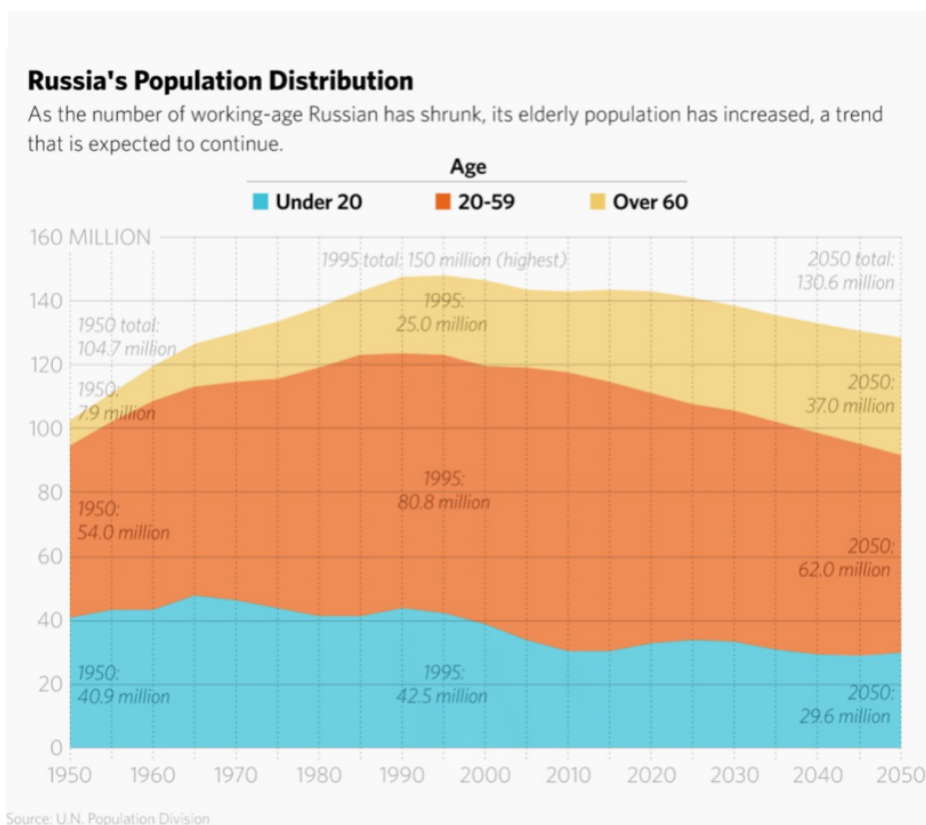
By the end of his second term in 2008, Russia was relatively stable financially and unified socially and politically, and it was surging back onto the former Soviet republics, which many considered Russia's return to the global stage. Putin benefited immensely from high global energy prices, which ensured a regular flow of finance into the state treasury and fund his stabilisation plan.

Whilst Putin has managed to stabilise the ship on rough waters, his next term will see numerous trends throw up new challenges. These challenges will likely be those that Putin's successor will also have to contend with.

## Demographics

The Slavic population played a central role in the Soviet Union's expansionist strategy in the past. The Soviet Union transferred large segments of its population to satellite states in Central

Asia and Eastern Europe to act as a bulwark for Moscow. The disintegration of the Soviet Union in 1991 did not just have political and economic consequences; it also had massive social consequences. Russians stopped having children, due to the uncertainty of the future of their welfare, as deaths increased with the collapse of Soviet territories. The Soviet health system crumbled, suicide and AIDS increased leading to deaths outstripping births. Russia's population on the eve of the Soviet Union's collapse was 148m; today it has declined to 143m, and continues to decline. Whilst in the past Russia's demographic was its strength, today it can no longer be used as such and this will worsen as an ageing population places a heavy economic burden upon a nation which will only be further exacerbated as the labour force continues to shrink.





*As a nation, Russia is a large, diverse and socially unstable country. Today, Russia has more than 185 different ethnic groups, 21 national republics and 85 regional subjects that span nine time zones. Every Russian leader - be they Tsarist, Soviet or post-Soviet - has struggled to consolidate this disparate population.*

these groups - this is to ensure an external power does not gain influence over them.

Russia's demographic trends all point towards Muslims becoming a large proportion of the populace. The current Muslim population of 16.7m is projected to increase to over 15% by 2030 as Russia's ethnic population declines which will make the Muslim population around 20m. As a tool, utilising the Russian population is becoming obsolete.

Putin in the first decade of the 21<sup>st</sup> century united the peoples of Russia in order to build a stronger country, but he never created a new identity for those people like the Soviets did. So the inherent divisions were bound to resurface. Such divisions have already led to mass protests, escalating conflict between Russians and Muslims, and the rise of new social and political groups hostile to Kremlin control. As Russia expands it will, in all likelihood, have more and more non-ethnic Russians in its territory: how Russia integrates them will impact its territorial cohesion. As the largest country in the world in terms of land area, Russia is comprised of a vast amount of territory that is home to a number of distinct ethnic groups. This means that to survive as a major power, Russia must control

#### RUSSIA'S ETHNIC REPUBLICS AND GROUPS



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# Economy

The last decade of the Soviet Union was not kind to the Russian people. The Soviet economy was struggling under the weight of the arms and space race with the US and the collapse of the Soviet Union in 1991 ushered in an economic depression that resulted in economic collapse. Millions were plunged into poverty as hyperinflation set in and as rampant corruption took root. Attempts by the Yeltsin regime to implement the shock therapy of privatisation and move from a centrally planned economy to a free one just made matters worse. It was not until 2000 with the emergence of Vladimir Putin that the economic situation began to change. Putin immediately began to clean house. Russia's internal consolidation began with the Kremlin regaining control over the country politically, economically and socially while re-establishing its control over Russia's wealth of energy reserves. The recentralisation of the Russian state resulted in the nationalisation of key sectors, assets, utilities and industries. Putin brought each of the nation's key sectors under Kremlin's control one after the other. He dealt with the oligarchs who were essentially looting the nation by threatening them with state intervention in the empires that they had amassed. They were told their future wealth would be determined by how much business they could grow rather than how much they could pillage. In this way, Putin was able to stabilise the domestic economy. Russia

contains the world's largest proven natural gas reserves, second-largest proven coal reserves, third-largest known and recoverable uranium reserves and eighth-largest proven oil reserves. However, from an economic development standpoint, Russia is anything but well endowed. There is no doubt the Russian economy has improved miraculously, to the extent it now has a current account surplus second only to China. But most of this is predicated upon the price of oil, gas and other minerals. The economic revival is by no means based upon a return to the Soviet era when manufactured items from motor cars to complete nuclear power plants formed the bulk of Russian exports. Russia's oil and gas production and pipeline projects have not only been a primary source of Russia's economic growth, but also a geostrategic lever in the country's relationship with Europe and Asia.

Russia supplies nearly 33% of Europe's oil and natural gas and energy revenues make up approximately 50% of the Russian government's budget. Almost all of Russia's \$500bn exports are mineral and metal related. Consequently, the energy sector is the primary pillar of the Russian economy. Aside from its mineral industries, years of low investment continue to leave their mark on Russia's industrial capabilities and a lot of its equipment is in need of modernisation.

In an increasingly multi-polar world, the economy of a nation

is one of the most important factors contributing to its political influence. The 2006 and 2009 European gas crisis showed the considerable leverage that Russia has over this key commodity. However, the problem with the Russian economy is its narrow focus, most of the government revenue, Russia's balance of payments and trade surplus come from energy or metals. The Russian economy is too dependent on the global price of energy and metals and has failed to develop other industries with this surplus wealth. Without a developed electronic industry Russia lacks the skills in this area. Russia's IT industry has very little software developed today.

Despite an economy valued at \$1.5 trillion, the Russian economy is heavily reliant on energy and its associated services. This has an impact on utilising this as a tool as aside from exporting energy (as important as this is) the Russian economy is limited in using its economy as a lever globally. The US economy, on the other hand, leads to trade, investment, aid, innovation and export opportunities with the world.





The Russian economy is mostly based on energy, with half of the government revenues coming from oil and natural gas. Energy for Russia is the most important tool of political leverage around the world via energy relationships with other countries. Energy ties are something Russia has very publicly used as a political weapon, either by raising prices or by cutting off supplies. But Russia's reliance on fossil fuels has also created a major weakness. Russia remains heavily reliant on oil exports but it can't dictate the price of oil. Russia is dependent on an economic variable it can't control. This was the same problem the Soviet Union faced in the 1980s. It had to increase its military force while its major export, energy, plunged in price. This problem was instrumental in the Soviet Union's collapse. To avoid repeating this scenario, the Russians had to decrease their defence budget rather than increase it. Russia's primary oil-producing region - the Western Oil Basin - is in decline, which has been producing over 60% of Russia's overall oil production for decades. New fields in other regions such as the Yamal Peninsula and East Siberia will have much higher production costs and will require new infrastructure to transport energy to consumers. Russia's population is scattered across its vast territory, as a result, its natural resources are mostly found in unpopulated areas.

New producers are also coming online, such as Azerbaijan and Algeria, who can supply the European market through Liquefied Natural Gas (LNG), which is transported by ship instead of pipeline. Currently, there is only one liquefaction terminal in Europe, but there exist 28 regasification terminals in Europe, with plans for 22 more to come online in the next decade.<sup>24</sup> These plans circumvent Russia's pipeline infrastructure and bring the large reserves of Qatar and

Azerbaijan online. Currently, Russia has only one LNG

facility at Sakhalin-2, with plans for half a dozen more new LNG facilities across Russia's coasts.

Like most Russian energy firms, Russia's energy giant, Gazprom, has a reputation for being an outdated company in terms of its technical capabilities. This is why Russian energy firms have repeatedly tried to bring in foreign energy companies for their expertise on the more difficult or newer projects, which the Kremlin loathes since it does not want to rely on foreign assistance (particularly from Western firms) in its most strategically important sector. Russia has struggled to develop these capabilities indigenously.

The development of shale energy is also an ominous sign for Russia as it has always opposed fracking. It historically funded many of the anti-fracking movements around the world. Moscow's opposition to fracking stems from a fear that if more countries tap unconventional sources for oil and natural gas, the need for Russian oil or natural gas would start to decline. However, despite this, many countries and energy firms are embracing fracking and this global trend is set to continue. Even though Russia has had components of fracking technology for decades, it has never used these in a coordinated manner. Gazprom announced in 2013, that one of its subsidiaries became the first Russian company to drill a horizontal well as part of a hydraulic fracturing operation, commonly known as fracking. Russia remains far behind other countries in the world with this technology. The US,

as an example, is already consistently fracturing wells five times deeper than Russia.



Russia's key political tool has been its energy resources and the latest developments will no doubt impact this policy tool. Russia's biggest challenge is adopting new technologies and methods in its energy sector. Traditionally Russia has not indigenously developed these and relied on foreign expertise. With many countries looking to develop their own shale reserves, Russian energy may become diluted as these reserves come online.

# Values

The Soviet Union excelled in spreading communism, winning over many people from the West from labourers to intellectuals to politicians. Many around the world were attracted to the communist doctrine of shared ownership, the regulation of private ownership and the centrally driven economy. For seven decades the Soviet Union challenged the capitalist world and its position as an ideology.

The collapse of the Soviet Union led to the replacement of communism and as a result, Russia today, has nothing in the realm of ideology, values, thought, philosophy or culture to spread around the world. Russian foreign policy is not aimed at advancing any values but only to protect its strategic interests. Whilst the Soviet Union attracted many to the Communist ideology, today the world in no way wants to model itself on Russia or its culture. Much of the former Soviet republics today despise Russia and its culture, and are more attracted to the West.

The quality of governance in Russia has also failed miserably. In 2012 a number of large protests swept across Russia and people in the hundreds of thousands took to the streets. These demonstrations continued for months and had a very overt undertone of being anti-Kremlin. Modern Russia, like the Soviet Union, employed brute force as a strategy to contain protestors. Russia has used nationalism to maintain its domestic social cohesion, but Russian nationalism which is predicated on ethnic Slavic culture and Russian history of struggle is specific to the people of the region and is not something that can be used to attract people to Russia. Russia has no ideology or values to advance in the world and as a result, the US with its liberal values has been able to penetrate the former Soviet republics.



# Ukraine

Ukraine was the most important republic out of the 15 former member republics of the Soviet Union. Ukraine was one of the Unions largest republics and it remains the breadbasket of Russia. Ukraine's proximity to Moscow led to the development of its energy resources and the construction of energy infrastructure and pipelines. Due to this Russia currently supplies 80% of Ukraine's natural gas and most of Russia's energy to Europe transits through Ukraine. This links Ukraine's energy directly to Russia's. Ukraine is crucial to Russia; its industrial, agricultural and energy sectors are integrated with Russia's and it is a buffer between it and Europe. The loss of Ukraine would bring Europe right on its doorstep which

would be an existential threat. The uprising in Ukraine in late 2013 resulted in the overthrow of the pro-Russian President, who was replaced eventually by a pro-Western government in Kiev. Russia responded with the annexation of Crimea and a pro-Russia insurgency in eastern Ukraine. This kicked off a protracted struggle between the West and Russia, which continues until today. Russia has amassed 60,000 troops on Ukraine's border. It has deployed them to strategically important locations along the border. By the end of 2017, Russian forces were in a strong position to conduct an incursion or threaten regime change in Kiev more than they have ever been. But this has not taken place.



The fate of the contested eastern portion of Ukraine has slipped down the order of global priorities. In 2015, Kiev and Moscow signed the “Minsk agreement”, which stipulated a ceasefire and a special constitutional status for the rebel-held territories of the Donbas (aka. Donbass) region, which would re-integrate into Ukraine and hold elections. None of that has come into effect and the number of ceasefire violations runs into the thousands. So, a low-intensity conflict has become the grinding everyday backdrop.

The Russian war in Ukraine has been on hold since Russia got involved in Syria. Ukraine expects that once the Syrian operation is over there may be a lot more action in Donbas. Meanwhile, the Russians are spending a lot of money to maintain forces (and about a million civilians) in Donbas. Russia has spent billions of dollars in their effort to take Donbas and currently they control only half of it and Ukraine has upgraded its armed forces with the

intention of getting the Russians out of Donbas. Crimea is not even on Ukraine’s agenda anymore.

The conflict between Ukraine and Russia was mainly based around ground battles over control of eastern Ukraine. But in 2018 the stand-off in the Sea of Azov became the new area of contention. As this sea is reached via the 4.5km wide Kerch Strait, Russia declared the strait to be part of the Crimean peninsula and no foreign ship could enter it without Russian permission. As a result, Russians seized over a hundred ships trying to reach the Ukrainian ports of Berdyansk (aka. Berdiansk) and Mariupol that are on the shore of the Sea of Azov. Russia has effectively put these two ports out of business. The EU and US protested the Russian blockade but undertaken no actions to change it. The US it seems will not be conducting a FONOP (freedom of navigation operation) in the Sea of Azov, as it had done in the South China Sea. In September 2018 the Ukrainian government announced plans to

create a naval base in the Sea of Azov. Ukraine announced the deployment of two armoured artillery boats to the port city of Berdyansk on 8<sup>th</sup> September 2018. But Russia was and remains in a much stronger position than Ukraine in the area around the Black Sea. The Ukrainian navy possesses 66 combat and auxiliary naval units, as well as about 11,000 service members. In contrast, Russia’s Black Sea Fleet, which is headquartered in Sevastopol, boasts more than 2,800 vessels and 25,000 service members. And the disparity is not just in quantity but in quality as well. On average, Ukraine’s vessels are much smaller and weaker than those of their Russian adversaries.

The Sea of Azov is of critical importance to Ukraine’s economy, it is even more important since Kiev lost Crimea, as 80% of the country’s exports now pass through the body of water. After Moscow annexed Crimea, Berdyansk and Mariupol began to receive some of the cargo traffic that previously went to Ukrainian ports in the peninsula. But Moscow’s construction of the new bridge across the Kerch Strait, the only passage between the Sea of Azov and the Black Sea, has cut cargo shipments to the Ukrainian ports — and triggered the military build-up by both countries.

Despite Russia being engaged in Syria, it has been able to freeze the conflict in Ukraine and in 2018 escalate the conflict at a location of its choosing to keep the Kiev government weak. Whilst much of the world’s attention is elsewhere, the conflict in Ukraine continues, without any clear end in sight. Russia has ensured for the moment that whilst it cannot establish a pro-Russian government in Ukraine, it will ensure no one can also fully take the country.



# Syria

Russia intervened in Syria in 2015 and three years on it turned the tide against Bashar al-Assad. Aleppo

fell in late 2017 and what remained of the rebel stronghold was Idlib. Whilst the birthplace of the uprising in Syria was Daraa, Idlib has always been the rebellion's beating heart and the source of its strength. There are over 100,000 fighters and well-prepared defences in Idlib. Together with northern Aleppo, both territories have been the main conduits for weapons and supplies and the rebellion's window and door to the outside world. Idlib was the last refuge for the rebels, after Idlib, there is no other sanctuary to be deported too. Rebels and their families who have been displaced from other fallen enclaves all congregated in Idlib. But by far, from the perspective of the rebels, the importance of Idlib is that they perceive it as a viable *statelet* albeit a vassal of Turkey.

From the point of view of the Assad regime, Idlib is also of vital significance. Idlib is the gateway to Latakia province, the home of the Alawite sect which forms the backbone of Assad's regime. Hence taking Idlib was essential to securing the Alawite homeland and in essence, the rebels' considerable efforts to gain control over the province's principal cities were an attempt to use Idlib as a launch pad for an offensive into the Latakia province. In the end these attempts were scuppered by dictates from Turkey.

In July 2018 the Syrian regime mobilised its forces

south of Idlib province and Russia declared readiness for the battle for Idlib. Russia even held military exercises which included assets not involved in Syria, especially naval assets. These were the largest exercises in Russia's post-Soviet era. The whole world was awaiting the final onslaught in Idlib in September 2018 and even President Erdogan's reservations were ridiculed by Putin in a conference in Tehran on 7<sup>th</sup> September 2018. But a Russia-Turkey summit in Sochi on 17<sup>th</sup> September 2018 between Erdogan and Putin saw the onslaught on Idlib replaced by a demilitarised zone around Idlib.

Turkey opposed a full military operation, Turkish ministers said 'terrorists' should be identified and fought and a full military invasion was not going to achieve this. Turkey became an obstacle to the Russian ambition to eliminate the military factions in Idlib and reduced the regime and Russian invasion to demilitarised zones manned by Russia and Turkey.



## Has Russia Become the New Power in the Middle East?

The Russian military intervention in Syria in 2015 has been met with a wave of comments claiming that Russia has regained its global power position in the Middle East. Commentators from across the political spectrum view the US in decline and consider developments in Syria as evidence of America's waning regional influence. Many see Moscow having entered into the void created by the decline in the US position, as foreignpolicy.com put it: *"the Syrian war is over, and America lost."*<sup>25</sup> Some commentators have gone further: *"Obama thought Syria would be Russia's Vietnam: in fact, the Middle East has become Putin's playground. Thanks to diplomacy, arms sales and nuclear reactors - and Trump's policy chaos - Russia is back, big time."*<sup>26</sup> A senior diplomat from an Arab country recalls that early on in the Syrian war, he asked a US general with a command in the region what was the difference between the crisis in Syria and the one that had just ended with the overthrow of Muammar Gaddafi in Libya. The general responded with a single word: "Russia."<sup>27</sup>

Today, Russia's intervention in Syria and interactions in the Middle East are all cited as evidence of Russia's growing power in the region. Russia's resurrection of bases in Syria is cited as evidence of Russia's military muscle in the Middle East. Similarly, Russian's military sales and diplomatic relations in Egypt and Libya (especially with Khalifa Hiftar) are cited as evidence of political and military heft. The energy deals Russia signed with Saudi Arabia in February 2018 was described by rt.com as: *"challenging US dominance in the Gulf region."*<sup>28</sup>



# *Case study: The Russian Bear in the Middle East*

Russia has a long history with the Middle East. Imperial Russia attempted to expand into the Middle East through the Caucasus and the Black and Caspian seas leading to many wars with the Ottomans. The 'great game' between the British Empire and Imperial Russia took place in Afghanistan and Iran in order to define their respective frontiers. Imperial Russia attempted to be the main guardian of Orthodox Christian tradition and as a result the dream of retaking Constantinople always lingered in the minds of various tsars. The Middle East remained an elusive goal of conquest for Imperial Russia as the 19<sup>th</sup> century was ending. Russia's attempt to assert its status as the main guardian of Eastern Orthodoxy evolved into Pan-Slavism as it came to support the nationalist aims of the Slavic populations under Ottoman rule. What presence and influence Russia had in the Middle East was completely eclipsed by the European imperial powers whose political and economic ambitions were to define the region in the century to come.

Soviet Russia emerged as a superpower after WW2, along with the US. By 1947 the Cold War had begun between the capitalist leader the US and the communist state. Moscow took up the mission of spreading the communist ideology across the world and intended to dominate the Eurasian continent. The Middle East lay south to the USSR and held huge petroleum reserves which was important for the US to rapidly rebuild allies in Europe and Japan. Moscow supported communist movements in the Middle East and carried an anti-Israeli policy. The Middle East to align with nationalist, Middle Eastern regimes. Moscow attempted to provide military equipment and arms along with aid in exchange for influence: Egypt and Syria became the mainstay for this policy. The US sought to deny the Soviets access to Middle Eastern territory and inhibit the expansion of the Soviet sphere of influence. This defensive agenda through the guardianship of Zionism, coups and agent rulers was largely successful. The defeat of both Syria and Egypt in the Six-Day War in 1967 with Soviet arms undermined it in the region. By the time the Soviet Union entered Afghanistan in 1979 its position not just in the Middle East, but across the world was in decline. Bereft of any substantial ideological attraction the Soviet Union failed in establishing a foothold in the region.



Russia has been attempting to develop economic ties with the Middle East; apart from Turkey, these efforts have not succeeded to any significant degree. The level of economic cooperation with the Middle East remains modest. In the early 2010s, the value of co-operation (trade and services) with the entire Arab world was around \$10–12bn a year. Russian exports to countries of the ‘broader’ Middle East accounted for around 1.7% of total Russian exports in the years 2011–2013, rising to 2.1% and 2.5% in the years 2014 and 2015, respectively. Trade even with Israel (\$2.5–3bn a year) and Iran (around \$4bn a year) is at most modest. The only country which stands outside of this picture is Turkey, whose trade with Russia has reached \$30bn. Egypt is the only Arab state to report trade with Russia exceeding \$1bn a year. Russia’s number one export is energy, which is something the region has plenty of. But after intra-regional trade (9%) the EU is the region’s main trade partner, supplying 30% of all goods and services.

Russia’s foray into Syria and showcasing of new military equipment has seen many view this as the military ascent of Russia. The Middle East imports 32% of global weapons, the most of any region in the world, but Russia supplies a small amount of this. In 2016 Russia sold \$21.4bn in defence equipment to the region, Russia exports more to Asia, which is a far more important region for it. One state, Algeria, accounts for nearly half of that sum. Russia does supply to Egypt, Iran, Syria, Yemen, Iraq and Sudan but Algeria and Iraq make up 93% of all

Russia’s arms exports to the Middle East. Russia’s defence industry suffers from numerous problems from the collapse of the Soviet Union and the decade of chaos that ensued. Russian weaponry lags far behind the US in terms of effectiveness and technological innovation and now China wields a level of commercial influence Russia cannot compete with. China is also starting to dominate in high-growth areas such as unmanned aerial vehicles (UAV), where Russia is no match. Syria has been showcased as Russia’s military superiority, one must keep in mind its weapons met no real opposition on the battlefield. Despite Moscow’s tests and displays, questions about the full extent of these weapons’ capabilities remain.

On the political front Russia has presented no policies on the regions key issues. There is no Russian plan for the Zionist and Palestine issue, Russia in fact subscribes to America’s two state solution. The Kurds in the region, the Sunni-Shi’ah schism, the Islamic faith and its role in the region, the relations between the autocrats and the people: Russia has neither presented nor pursued any political plan for these. Russia has never had such level of influence to even be involved with such depth in the region. Whilst Russian officials may meet with the regions autocrats it is the US that dominates the politics of the region, despite not all US plans succeeding.

The simple fact is the regions which are critical to Russia and the ones it seeks to dominate, with political plans and influence are Europe, the Baltics, the Caucasus



and Central Asia. These are all buffer zones for Russia and without controlling these, the regions beyond these zones are beyond Russian capabilities. Even at the height of the Cold War the Middle East was not the critical region for Russia, despite it having more capabilities than it has today.

Russia’s political, economic and military presence is severely limited to pose a challenge to the US, in the Middle East. However, it’s relations with Iran, Turkey and Syria that are cited as Russian ascendancy in the region.







# Syria

The Soviet Union engaged in a confrontation with the US and “imperialism” in the Middle East. Syria has always been viewed as one of the Soviet Union’s key pillars for this. The Soviet Union equipped and trained the Syrian military and in subsequent years the Soviets provided military platforms and arms. Under Hafez al-Assad, a naval base in Tartus was opened and this was considered the height of Soviet influence in the Middle East. But despite deep military relations, Syria was never a Soviet proxy. Under Hafiz al-Assad Moscow and Damascus did not have the same views on many issues. He was difficult to control and managed to get more from the Kremlin than the other way around, whilst on the political issues in the region the US got more from him. Whilst Hafiz presented himself as anti-Israel, the country’s borders with Israel remain, even today, the most secure. Officers who served with Hafiz have all gone on to write about the defeats to Israel and how Hafiz’s actions in the 1967 and 1973 wars led to defeat.<sup>29</sup> The USSR did not share the same position with Syria on the introduction of Syrian troops into Lebanon in 1976, something, about which the Soviets were neither consulted nor informed. Even the country’s contacts with Hezbollah in the 1980s was at odds with the Soviet view. It was the US that Syria cooperated with in the Ta’if agreement that ended the civil war in Lebanon and kept Syria entrenched in the country in 1989, rather than the Soviets. After the collapse of the Soviet Union in 1991 the US continued in using Syria when it needed to achieve its goals in the region. Syria was the only non-monarchical state in the region to dispatch troops in the 1991 invasion of Iraq. In the 2003 invasion, Syria used its intelligence of the militant groups leading an insurgency in Iraq and passed this onto the US, something the Baker-Hamilton report of 2005 viewed as a basis to cooperate more with Syria.

Russia’s naval facility in Tartus has always been held as a sign of Russia’s strength, but in reality it plays a very limited role for Russia as its navy has been scrapped, sold off, or rusted away in port since 1991. On the seas Russia’s biggest threats are not NATO or the US, but its rusting shipbuilding industrial base and poor maintenance. Indeed, more Russian warships have been lost to shipyard fires than any enemy action. Russia’s military has always been land-centric, rather than based on sea dominance.

Under the USSR, the Soviet Navy steadily increased in strength across the Cold War, bypassing the French and British fleets and becoming the world’s second most powerful navy. But Russia has never been a major naval power. At times Moscow has established itself as a coastal naval power, but it never had a truly global reach on par with historic powers like England or Spain. Russia, whether the Soviet Union, Empire or today as a federation, suffers from the same maritime handicaps - the Russian Navy is divided between four different fleets: Black Sea, Baltic, Northern and Pacific, none of which can easily support the other.

The facility in Tartus was agreed between Moscow and Damascus in 1971 when the Soviets wanted to increase the depth and intensity of its strategic relationship with numerous Arab and North African states. Algeria, Libya, Egypt, and Syria received significant military and economic aid from the Soviet Union. As these relationships progressed, the Soviet Union identified a need for a permanent military base in the Mediterranean to support naval training and exercises. The agreement in 1971, allowed Soviet surface combatants, submarines, and cargo ships to use port facilities at Tartus. During the Cold War, Soviet ships regularly pulled into Tartus for supplies and maintenance. Following the end of the Cold War and the collapse of the Soviet Union, the Russian Navy suffered a steep decline in readiness and expeditionary capability. As a result, the Russian base at Tartus fell into a state of disrepair. Up until 2017, Russian official usage classified the installation as a Material-Technical Support Point (Russian: Пункт материально-технического обеспечения, ПМТО) and not as a “base”. Until recently there were only basic support functions at the facility and there is still no command and control facility. The rather limited capabilities of this facility which was until recently a glorified petrol station, falls well short of being a base for regional power projection when it can only accommodate four medium-sized vessels, but only if both of its 100m (330 ft) floating piers, inside the northern breakwater, are operational. It is not (yet) capable of hosting any of the Russian Navy’s current major warships. The facility can host high-profile visits by a few ships and allow them to spend a little more time in the Mediterranean Sea but are not suitable for sustained and extended large-scale military operations.



The Iran-Russia relationship has long been viewed as Russia's power play in the Middle East. As Iran has been isolated in the region the military, trade and political cooperation between the two countries have only deepened. But relations between both nations has wavered from collaboration and rivalry throughout history.

Both nations are separated by the Caucasus, the Caspian Sea and Central Asia. These regions are important for both nations for their own protection, for power projection and for trade routes and the mineral wealth there. Tsarist Russia expanded territorially into wide parts of what had been part of "Greater Iran" in Central Asia and the Caucasus. Tehran lost Tbilisi and Baku to Russia in the 1813 Treaty of Gulistan. At the turn of the 20th century, Iran had irreversibly fallen behind the imperialist powers and was subjugated into a de facto quasi-colonial dependence, being divided into a Southern British and a Northern Russian sphere of influence by the Anglo-Russian Convention in 1907, an imperial division which in effect survived as a Soviet-British occupation into WW2.

Relations deteriorated when Iran in May 1979 unilaterally annulled articles of the 1921 Soviet-Iranian treaty providing safeguards for mutual neutrality in case of third-party aggression. Likewise, during the Iran-Iraq war, the Soviets pursued an ambiguous policy of providing both sides with weapons (as did the US), but began to supply more weapons to Iraq after 1982. After the collapse of the Soviet Union in 1991 relations improved and Russia began work on constructing Iran's nuclear reactor in Bushehr. US pressure increased upon Iran and it became clear it was perusing a nuclear programme and as the US was drowning in the Iraq insurgency relations between Iran-Russia grew wider and deeper as it was isolated from the region and much of

the world. Iran's military increasingly turned to domestic production and Russian platforms. China and the UAE remain Iran's main trade partners.

Politically Russia and Iran have different views of the region, how it should look and each other's roles. Iran sees itself as a regional power, it has designs on the region and it has developed the tools to achieve these. The challenges Iran faces in achieving this is Saudi Arabia, who argues it represents the global Sunni population, Israel and the global superpower — America, who

*Politically Russia and Iran have different views of the region, how it should look and each other's roles. Iran sees itself as a regional power, it has designs on the region and it has developed the tools to achieve these.*

doesn't want to see anyone dominate the whole region. Iran is in a real struggle in the region and it is a resident of the region. Not being a resident of the region, supporting any nation against the US in the region achieves Russia's interests. Support from Russia allows Iran to come across much more powerful than it really is, but Iran has achieved most of its regional ambitions without much Russian support. The Islamic

Revolutionary Guard Corps (IRGC), Hezbollah and the Shi 'ah crescent have achieved for Iran much more than Russian support ever has. As Iran has been isolated from the regional nations and much of the world, Russia gives Iran an insurance policy from isolation, but aside from the image this creates, Russian relations have given very limited results in the Middle East. Iran-Russian relations give Russia the opportunity to play spoiler in any US actions in the Middle East, complicating US plans and this limitation keeps Russia well behind the US in determining the future of the region. Given the opportunity of recognition by the US, Iran's leadership would happily sacrifice what relations it has with Russia. In Iraq, in Afghanistan, Iran has done much heavy lifting working with the US and not Russia. Whilst both Russia and Iran present their relations as an alliance, it is very far from it.



# Turkey

Turkey and Russia are separated by the Balkans, Black Sea and the Caucasus and these regions have served as a constant area of competition and war between both nations. From the 16<sup>th</sup> century until the early 19<sup>th</sup> century both as empires fought at least 11 wars (including the Crimean War), cementing their long-standing rivalry. But by the mid-1800s the Ottomans were in decline and the Russian Empire used this to engage in a number of unequal treaties where the Ottomans were forced to surrender many territories. It was Russia's expansion that led to the British Empire to also intervene. The Bolshevik revolution in 1917 and their support to Turkish revolutionaries and nationalists against the Ottomans led to a warming of relations. But the emergence of the Soviet Union after WW2 as a global power saw Turkey firmly integrated into America's containment strategy. Following the dissolution of the Soviet Union in 1991, relations between Turkey and Russia improved significantly and the two countries came to rank among each other's largest trade partners.

Turkey's rise has been parallel to the rise of Recep Tayyip Erdogan. Erdogan from his very first days in power aligned with the US. This was done in order to strengthen him and his AKP party in the face of the Kemalists. In 2006 Condoleezza Rice as US Secretary of State and Abdullah Gul as Turkish President signed a shared vision document that aligned their regional agenda. In reality on the two-state solution, Afghanistan, Black Sea, NATO and terrorism: the US developed the strategic plan and Turkey implemented it. Erdogan has since risen to global prominence in this role and justifies this as pursuing peace and stability and his country's own

national interests. Turkey has been very effective in executing America's strategic agenda within the Middle East and beyond.

This was made possible as Erdogan is furthering his own personal prestige rather than any grand strategic agenda, working with the US raises his stature.

Where Turkey has attempted to present plans, Erdogan has been slapped down. Erdogan proposed a no-fly zone in Northern Syria in 2016, but this was refused. Erdogan has a close relationship with the US and this has been a central reason for his rise. But the recent disagreements over the Kurds in north Syria and an apparent warming of ties in Syria between Russia and Turkey does not mean Russia has replaced the US as Erdogan's indispensable partner.

Whilst there has been much cooperation in Syria between Turkey and Russia, both had troops and air assets on the ground and some level of interaction would be needed as both are engaged in the same battlefield. Numerous meetings, conferences and summits have taken place from Sochi, Tehran, Astana to Istanbul over de-escalation zones, rebel groups and the future of Syria. Russia has portrayed this as Turkey joining Russia as an ally and not needing the US. Erdogan and many of his officials have used its meetings with Russia to project an image of strength, but Erdogan has brought the rebel groups in the north to the negotiating table, he trained and armed the

FSA which consisted of many defected soldiers — none of these are against America's strategic agenda in the country or the region. If anything, these actions aided America's strategic agenda of maintaining the status quo.

Where differences did emerge with the US was over the Kurds in North Syria. America armed the Kurds in order for them to take on the other rebel groups. Erdogan opposed this as it would strengthen the Kurds, who support the PKK, who continue in their insurgency in Turkey. But Erdogan viewed himself as playing an effective role in the American agenda and argued the US didn't need the Kurds as Turkey was playing an effective role in Syria. When Turkey moved its forces into Manbij where Kurdish forces were present along with US troops an agreement was reached where Kurdish forces were forced to leave the area. For the US, Turkey plays a role and it views the Kurds as playing a role. Both Erdogan and the Kurds work with the US to strengthen their own positions. So, whilst both Erdogan and the Kurds may have differences with the US, these are in operational details, not on the strategic agenda.

Russia has no comparable relationship with either Turkey or the Kurds. Russia has an energy relationship with Turkey on the politics of the Middle East; Russia does not have the depth in relations to do what the US can. Russia has only been able to play spoiler by using Turkey and Bashar al-Assad as tools, but nothing more.



# Russia's political moves in perspective

Whilst many may believe we are on the cusp of the regional balance of power changing in the Middle East, the reality is Russia boasts a lot more than it really achieves, playing with a diminishing hand. An examination of

these moves shows they are defensive and largely commercial deals as well as diplomatic in nature that have been pursued that lack the depth to have any impact on regional issues.

Vladimir Putin has been firmly fixed on regaining Russia's periphery i.e. the former Soviet satellite states as these have always been a buffer to foreign invasions. The US strategy has on the other hand been to pry these nations away from Russia. But the Middle East remained mainly an export market for Russia's decapitated defence industry as the region was awash with rusting Soviet military platforms and Russia maintained its economic interests with the region due to the region's influence on oil prices.

Despite the mantra across the world and even what comes out from the US media, Russia's role in the Middle East considering the multitude of issues is surprisingly very little. Its actions in Syria no doubt have made a difference, but these have not translated into real influence. Moreover, Russia has failed to clearly articulate its goals and interests in the region.

The Middle East is less important than Europe and Asia to the Kremlin's national security strategy. This is apparent in the 2013 and 2016 Russian Ministry of Foreign Affairs Foreign Policy Concept Papers. In

both editions, the Middle East is listed near the end of the section on "Regional Priorities," illustrating its relative lower priority in Moscow's worldview. Russia sees relatively limited opportunities in the Middle East to protect or advance vital national interests. This assessment frames its actions in the region.<sup>30</sup> Russian foreign policy is guided by near-term pragmatism and not by long-term plans or regional designs.

Russia seeks to be able to effectively influence and shape outcomes, but a lack of means limits what it can achieve. Even if Russia wanted to pursue a comprehensive longer-term strategy in the Middle East, there are significant limitations to what it could achieve. Russia potentially lacks the economic and military power to sustain a long-term strategy. It is already questionable how long Russia can sustain its current actions. While Russia has achieved some important short-term goals, mainly in Syria, it's doubtful Russia has the resource-depth or capacity to achieve a long-term strategy.

*Further from the Middle East there is no global struggle between Russia and the US over the world. Russia lacks the capabilities to challenge the US global position and as a result it is focussed on its region. Russia has cooperated with the US in certain nations and regions as it suits her interests to do so and this does not affect the countries short-term or strategic security. Although these actions aid the US in the execution of her global agenda, for Russia the cooperation achieves financial, defence and political interests.*





# Russia Crafts Response to US sanctions

International sanctions were imposed on Russia during the Ukrainian crisis by a large number of countries following the military intervention in Ukraine, which began in February 2014. The sanctions were imposed by the US, the EU and other countries and international organisations against individuals, businesses and officials from Russia and Ukraine. The sanctions by the EU and US continued in 2018 and have contributed to the collapse of the Russian rouble, causing a recession and a financial crisis.

The US steadily ramped up its sanctions against Russia since 2014. Congress played a central role in gradually expanding sanctions, especially through motions such as the Countering America's Adversaries Through Sanctions Act, which passed in August 2017. The legislation not only expanded sanctions against Russia but prohibited US President Trump from lifting any existing sanctions against Moscow in the absence of congressional approval of a detailed report of Russia's concessions on the matter. This act in essence ensured that Congress and not the president, wields the power to adjust sanctions against Russia.

Following the passing of the act, the US Treasury submitted the 'Kremlin Report' that led to the implementation of harsh sanctions in April 2018 against a number of Russian oligarchs, their companies, government officials and a bank. The measures, however, particularly hurt the world's second-largest aluminium company, Rusal, and its owner, Oleg Deripaska.

In total, the US Treasury Department's Office of Foreign Assets Control (OFAC) has targeted nearly 500 Russian individuals and entities with sanctions, depriving the affected firms of a quarter of their average revenue and costing the overall Russian economy tens

of billions of dollars. Because of its dependence on the US market, Rusal has suffered even greater losses, shedding more than 50% of its stock market value.

As the pressure increased, Moscow continued in 2018 to duck, jump and weave to avoid the harshest blows. The Kremlin remains defiant and has attempted to fight back. Russia has attempted to execute both short-term and long-term strategies to insulate its people, businesses and economy from Western penalties.

In the short-term Russia's central bank has sold its US Treasury holdings as a form of divestment while accumulating more gold. A higher value-added tax that will enter force in 2019 and this will lower the price of oil that Russia needs to balance its budget to around \$50, the lowest since 2008. Russia reformed its pension system, which was deeply unpopular, but aims to improve Russia's fiscal position. Major Russian companies, including Norilsk Nickel and Alrosa, are experimenting with mechanisms to use roubles, instead of dollars, in settling payments to foreign customers in countries like China and India. Russia's longer-term strategy consists of the revamping of its fiscal and monetary policy and instituting an enhanced tax collection system under which it can balance its budget at a lower price of oil.

Whilst the US has hurt Russia, Moscow has a strategy to survive these sanctions and has made decisions which should blunt the long-term effects of US actions.

*The fact that Russia faced a recession from US actions indicates how far apart Russia is from the global super power, but despite this Russia continues in its attempts to rebuild itself and possibly one-day challenge the US.*

# A Stealthy Death

For Russia, strength has always been measured in military capabilities. This mentality literally drove the Soviet Union into the ground during the Cold War in the arms and space race with the US. Russia's entry into Syria has been used to showcase Russia's military capabilities, but in June 2018 the discreet cancellation of the much and for so long praised Sukhoi Su-57 fighter took place.

In June 2018 the government announced that it decided to begin production of the Su-57 and the contract for 12 of them was ready to sign. In early July however it became obvious that this contract would not be signed, given that the factory that was to do the work was not hiring the workers or ordering the Su-57 components. When pressed, defence ministry officials admitted that mass production of the Su-57 was not going to happen as planned, which is a common phrase for defence projects that are facing termination or long-term delays.

In February 2018 India withdrew from the Su-57 joint development and manufacturing agreement because the Indians concluded that there was no Su-57. The original agreement committed India to eventually contribute over \$8bn to developing and building Su-57s. India said they might still purchase the Su-57



once it is ready for sale and might even rejoin joint development efforts. But for now, India is writing off nearly \$300m it has already invested but is no longer obligated to spend over \$8bn to develop and manufacture an aircraft they have lost confidence in. That loss of confidence was confirmed about the same time when two Su-57 stealth fighters sent to Syria conducted two days of testing their sensors and countermeasures over Syria and returned to Russia by the end of February 2018. The reality was that all the Su-57s could do was land and take off. There were no sensors and countermeasures to test.

The Su-57 suffered from design flaws and fixes were not available. This project was way behind schedule, while China already had one stealth fighter in service and others about to be. The Russians have been getting close up views of the Lockheed Martin F-35 because the Zionist entity put its first F-35 squadron into service. That included flights into Lebanon and Syria. The American F-22 stealth fighter has been operating over Syria for years and Russia got a good idea of what they were up against and why the Su-57 was no match for the two stealth aircraft and that Russia did not have the resources to make the Su-57 competitive.



# Case study: Russia's Syrian Intervention

It's no secret that Russia used its military campaign to both demonstrate and test hardware, and furnish its forces with some actual combat experience. In March 2016, Russian President Vladimir Putin said that combat operations in Syria are the best form of training for his country's armed forces. *"The Russians quickly began to see Syria as a testing ground for various weapon systems that hadn't been used in combat before as well as an opportunity to give various branches of the military experience in an actual war zone,"* Michael Kofman, a specialist on the Russian military at the Wilson Center's Kennan Institute, told War Is Boring.

Russian combat aircraft in Syria averaged 100 such as which occurred in more than 30-50 combat aircraft

Neil Hauer, an expert on closely, pointed out some of the Syria compared to past conflicts. *frontline units than in the Donbass army units were engaged in full in Syria. Instead, Russian forces infantry (reconnaissance and roles to date have been*

Many of Russia's bombs had Kofman noted. This indicates did in the early 1990s. The Syria amounts to *"perhaps its campaign in Syria proved and also demonstrated other also revealed serious limitations.*

For instance, Russia carried out and Su-25SM aircraft, which drop precision-guided bombs. 34 Fullback multi-role fighters general trend since they 500S satellite-guided of Russian warplanes targets with precision-proven extremely these aircraft relied weapons and bombs their intended targets, describes as *"overkill."*

As with its Soviet predecessor, can maul its enemies *"in continues to struggle when finding and seeing its* Kaufman said. production of drones the Russian military produced reconnaissance and surveillance drones, along with some license-built Israeli models, it has no armed drones to speak of therefore lacks a *"recon-strike capability,"* Kaufman added.

Also Moscow's use of naval aircraft in Syria failed to impress given the abysmal deployment of the aging *Admiral Kuznetsov* aircraft carrier in late 2016, which lost an Su-33 and a MiG-29K in accidents.

Overall, Russia's campaign in Syria has been a mixed bag. It certainly showed improvements in tactics, strategy and capability. At the same time, it demonstrated that Moscow has plenty of room for improvement when it comes to conducting conventional military operations beyond its vast frontiers.

averaged 40-50 sorties per day, with peaks as high as January 2016. Russia achieved this without deploying and 16-40 helicopters to Syria throughout the campaign.

Russia-Syria relations who has followed the conflict improvements the Russian military has demonstrated in *"I think there's been an implicit focus on using fewer conflict,"* Hauer told War Is Boring. *"While Russian frontline battles there, there's been nothing of the sort have acted in support roles in the guise of advisers, light artillery spotting), and air support. The only real combat played by Wagner [Group, private Russian] mercenaries."*

far greater payloads than necessary for their targets, that Russia still, more-or-less, fights the same way it proportion of precision-guided weapons used by Russia in *less than five percent*" of the total, Kaufman said. While that Russia is capable of using long-range guided weapons improvements in the air since its 2008 war with Georgia, it

most of its bombings in Syria with older Su-24M2 lack targeting pods needed to The use of newer Russian Su- were the only exception to this are capable of dropping KAB-bombs. Furthermore, the ability to hit small, moving guided munitions has limited. Instead, on unguided far too big for which Kofman

the Russian military close quarters, but it comes to actually intended targets,"

Russia lagging in the also hasn't helped. While does possess domestically-



# Post-Soviet Russia

The disintegration of the Soviet Union resulted in the newly independent states dividing up the Soviet Union's military's assets. The Russian Federation inherited the largest and most productive share of the former Soviet defence industry, employing as many as 9m workers in 1,125 to 1,500 research, design, and production facilities. Most Russian defence enterprises steadily lost their best workers to Western companies. In 1997 the Russian defence industry consisted of some 2.5m workers. In dealing with this situation, the Kremlin came to rely on its nuclear arsenal as the guarantor of territorial integrity.

The decade after the collapse of the Soviet Union led to economic and financial chaos leading to the deterioration of arms and equipment due to inadequate servicing. Today up to 90% of this equipment has not been maintained or can no longer be used.<sup>31</sup> Russia's defence industry is today a relic of the Cold War era.

Russia's ground forces have very large stockpiles of materiel left from the Soviet Union. This equipment in the main is part designed or built by Soviet era engineers, is either obsolete, or requires significant upgrades. The army particularly lacks precision-guided munitions and modern command, control, communications, computers, intelligence, surveillance and reconnaissance systems.

The Russian Air Force has over 4,000 aircraft in active service, but as with the army overall, its equipment consists of vast numbers

of ageing platforms first built during the Cold War. Much of these fleets have been badly serviced. In 2008 a MiG-29 crashed as subsequent investigations brought to light that the plane suffered from metal corrosion. All of the MiG-29's were grounded and checked for air-worthiness and it was found 70% were not operational.<sup>32</sup>

The Russian Navy is not as powerful as it used to be. The decay of the 1990s affected vast numbers of ships that suffered from lack of maintenance and upkeep. The Russian Navy has not played any role in Russia's post-Soviet wars – Chechnya and Georgia. The shortage of finance in the 1990s led to shipbuilding to largely discontinue until early 2000s. Russia currently maintains a sizeable number of warships, but most of these are old Soviet and now obsolescent designs. The Russians have not built a large surface vessel for the military from scratch in more than 20 years. The refurbishment of India's INS Vikramaditya aircraft carrier, at the shipyard in the Russian city of Severodvinsk, was beset by constant delays and obstacles, highlighting Russia's declining ability to work on large military vessels.

Russia continues to maintain a sizeable nuclear arsenal and delivery systems. Russia has approximately 1,499 deployed strategic warheads, and another 1,022 non-deployed strategic warheads and approximately 2,000 tactical nuclear warheads. Russia's nuclear forces have not escaped the military decline

of the post-Soviet years. Many of Russia's nuclear weapons and their delivery systems have exceeded their design life, with some estimates suggesting that increasingly obsolete capabilities form some 62% of the Russian strategic missile force.<sup>33</sup> Going forward many of Russia's existing delivery systems are due to be decommissioned by 2015. Efforts to replace those capabilities have had mixed success.

Russia has made small amounts of advanced weaponry, which has been widely acknowledged. In the last few years, the air force has taken delivery of the Su-34 combat aircraft, the Iskander theatre ballistic missile system, the S-400 air defence system and the BMD-4 airborne combat vehicle. These platforms are considered amongst the best in their category.

Russia possesses a very sizeable arsenal, which suffers with deep structural problems associated with age and the lack of maintenance. As the equipment continues to age, maintenance becomes more expensive, taking up more of the defence budget. The equipment will also be retired at an ever-increasing pace as it becomes obsolete. The Russian military therefore is dependent on increased military funding which has been problematic due to sanctions, falling oil prices and recession. Due to the decade of crisis after the collapse of the Soviet Union, Russia's defence industry was neglected and this has impacted the development of new platforms. This was the underlying problem with the Su-57.



# Conclusions

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## Russia has been shouting much louder than it is capable of

and presented itself as a global power. But its key strategic regions are all its former Soviet republics which all are looking to the West. Russia has been able to maintain influence in some of these nations, whilst in others it's looking to gain influence. The global super power is forced to take Russia into account to achieve its interests and as a result Russia remains a power, although its influence is largely regional, rather than global. Russia is a power, just not like the one it was before, and this means it has a seat at the table of global issues. Its ability to bend the international situation to its liking is extremely limited, but Russia projects an image of strength and this is important internationally.



# 2019

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### Arms Race:

With the US leaving the Intermediate-Range Nuclear Forces Treaty (INF) this will intensify ongoing military build-up by the US against Russia. Russia will need to fight back and has a military presence and assets in Kaliningrad, western Russia, Crimea and the Black Sea. The US has a global presence, whilst Russia doesn't, it will therefore need to make moves in 2019 and beyond to show it can engage in multiple regions and defend against US interjections against it.

### Russia's Narrow Economy:

Russia's economy has historically been driven by wheat production and energy, these sectors stimulate the wider economy. The economic crisis that hit Russia as a result of Western sanctions have hurt Russia and forced it to make internal reforms. These reforms have been painful which included pension reforms i.e. forcing Russia to work longer. But unless Russia can begin the process of creating a more diverse economy, its domestic issues will catch up with it.

### New World Order:

With the withdrawal of the US from the Intermediate-Range Nuclear Forces Treaty (INF) on top of sanctions, Russia needs to respond to the US in order to deter it. Its partnership with China is central to this. In 2019 Beijing will increase its investment in building factories, pipelines, roads, railways and other infrastructure projects in Russia. They will in all likelihood increase the size and scope of their joint military exercises. But what is lacking is what the world should look like, a new order for the world to integrate into. This would be a response that would really challenge the US world order.





# European Union

*The EU faces its biggest test since its inception. Trust, scepticism, rising nationalism and the rise of the far right are all pulling the union in different directions. Britain has started the process of leaving the union and this will become a model for other nations. The EU has continued to forge ahead in 2018 on continental integration as a solution to its many problems. But the survival of the EU continues to be at the very core of all discussions in trying to maintain it.*





In a New Year's Eve speech to the nation, German Chancellor Angela Merkel outlined a vision for her fourth term that included an alliance with French President Emmanuel Macron to strengthen Europe's economic clout and control migration, while upholding values of tolerance and pluralism within the EU and abroad. *"Twenty-seven countries in Europe must be impelled more strongly than ever to remain a community. That will be the decisive question of the next few years. Germany and France want to work together to make it succeed."*<sup>34</sup>

On 5<sup>th</sup> February 2018, the European Commission released a report outlining its strategy for the six countries in the region — Albania, Bosnia-Herzegovina, Kosovo, Macedonia, Montenegro and Serbia — that aspire to joining the EU. In the document, the commission outlined a plan for the bloc to increase cooperation with the Western Balkans on issues such as security, the rule of law, immigration, and infrastructure for energy and transportation. However, the document also stated that none of the countries are expected to join the European Union (EU) until at least 2025, and it warns their governments that they must introduce important political, economic

and institutional reforms before they can become EU members.

This new policy was a reversal from Brussel's stance in 2014, when European Commission President Jean-Claude Juncker said there would be no EU enlargement in the foreseeable future. Under the new policy, Brussels set 2025 as the target for Serbian and Montenegrin membership. It also pledged "enhanced enlargement" in the region to help prepare the other countries such as Albania, Bosnia-Herzegovina, Kosovo and Macedonia.

Montenegro's membership was a foregone conclusion once the country joined NATO in June 2017; an unspoken rule among NATO and the EU since the Cold War ended is that membership in one group comes with membership in the other. Serbia was the exception as it has little interest in NATO membership. But Germany has also wanted Serbia in the EU, as it recognises Serbia as the most important state in the region because of its strategic location. This is why Germany established the so-called Berlin Process to keep ties alive during Juncker's five-year freeze on enlargement. But progress was slow because there were few incentives for the Western Balkans to cooperate. The above document demonstrates

the EU's quandary in the Balkans. On the one hand, the bloc is keen to preserve its influence in the region — especially since Russia, Turkey and even China have become active there. The promise of EU membership is an important stabilising factor in the Western Balkans, enabling Brussels to influence the region and prevent a return to the instability of the 1990s.

The European Commission needs to keep the promise of EU membership alive for the countries in the Western Balkans, while also telling their governments not to expect membership in the near future. Even the goal to add new members in 2025 is easier said than done. Serbia has made the most progress towards EU accession, but it still needs to finish normalising relations with Kosovo first. Kosovo, for its part, is not recognised by all the EU member states, and Macedonia is still embroiled in a dispute with Greece. Bosnia remains weak, ineffective and its political institutions after two decades are still weak. In all six countries, the EU is concerned about corruption, weak institutions and organised crime.

The EU needs to push positive future trends in an era where all the news is negative from the rise of the far right to Brexit.



# Migration

Migration to the EU has become a major issue across the political spectrum on the European continent. It has led to the rise of the far right and has caused major friction between member states. It took a marathon summit in Brussels lasting more than 12 hours on 29<sup>th</sup> June 2018 for EU members to agree a new deal. The deal was a compromise between the conflicting interests of southern, northern and eastern EU members, who all have very different approaches to immigration.

The plan called for stronger controls at the EU's external borders; for more cooperation, funds and resources for the countries of origin and transit of migrants; and for a more decisive fight against human trafficking.

The biggest problem and the most controversial question was how to deal with migrants once they reach Europe. Italy, which is located in the middle of the Mediterranean, wants more unity from other EU members in dealing with migrants. This is unacceptable for many countries, particularly those in Central and Eastern Europe, who are against any proposals to distribute migrants across the bloc. The German government has remained under significant domestic pressure to put an end to so-called secondary movements, where people come to Germany after having

entered Europe through another country. Against this political backdrop, the members of the EU ultimately established a plan that makes three main proposals.

The first is to create “regional disembarkation platforms” outside of the EU, to take people who are rescued at sea. This will require cooperation from non-EU countries, mostly in Northern Africa, who must be willing to open such reception centres. The EU believes these platforms would be handled in cooperation with the UN refugee agency, UNHCR, and the International Organisation for Migration, European media reported that these organisations have already warned the union against trying to open migration centres in places that are unsafe for migrants.

The second proposal was to open “controlled centres” within the EU, to distinguish between economic migrants and asylum seekers, who have the right to apply for asylum. But these controlled centres will be voluntary, which means that every EU government will get to decide whether they want to open one.

The third agreement called for more cooperation to prevent secondary movements within the EU. This was added to please German Chancellor Angela Merkel, whose political allies in the Christian Social Union party want



her to introduce tougher measures on immigration. In addition to the bloc-wide agreement, Merkel also negotiated bilateral agreements with countries that were willing to receive some migrants who do not have the right to apply for asylum in Germany. While Greece already has expressed interest in a bilateral agreement with Germany, other key countries, such as Austria and Italy, were not convinced.

The problem with this migration agreement was notable for what it omitted. Despite Italy's requests, the group did not reform the controversial Dublin system, which dictates that the country where a migrant first enters the EU is the one responsible for them. Italy and other southern European countries argue that this system puts excessive pressure on the Mediterranean countries, and they have demanded more participation from other members of the union. But opinions about reforming the Dublin system are so divided that, once again, the EU has kicked the can down the road and promised to discuss the issue again in the future.







# Reforms

In 2018 the EU began discussions on the kind of bloc it wants to be. Whilst EU members were meant to discuss a range of reforms in reality France

and Germany came up with a range of measures for the rest of the union to discuss in the form of the Meseberg Declaration on 19<sup>th</sup> June 2018.

A record influx of refugees fleeing war in Syria and Iraq, has become a defining issue for politics in many EU nations. Angela Merkel faced a domestic rebellion over her policy that led to the arrival of more than a million asylum seekers since 2015 and Italy sparked an outcry by refusing aid ships carrying rescued refugees to dock in its ports. Paris and Berlin agreed that EU countries must be able to turn back at their borders all asylum seekers who previously registered in another member country, usually their Mediterranean first port of call. Merkel confirmed Berlin can offer other EU countries the EU-Turkey deal in which the bloc paid Ankara for housing and schooling refugees. The German leader had initially championed a quota system to distribute migrants across the bloc, but this was torpedoed by several Central European nations.

On the economic and political front Macron's ambitious ideas for a eurozone finance minister were shot down by Berlin. Both however agreed a eurozone budget that will be used to finance projects on innovation and education in poorer EU countries. The eurozone budget will have its

own governance structure and be a real budget with annual revenues and spending to be in place by 2021. Beyond the budget in order to better cope with future crises, the two leaders agreed to expand the remit of the current European Stability Mechanism (ESM). The twin EU engines now want the ESM to become a European version of the IMF that could provide emergency loans to countries that fall victim to crises not linked to their debt levels.

In the face of US President Trump's "America First" policy, a traditionally pacifist and Atlanticist post-war Germany has drawn closer to France's call for a sovereign Europe, including its own defence force. Merkel backed Macron's idea for a European

intervention initiative, with armies

to collaborate before eventually forming a common force.

But France wants this force outside the framework of the EU, to allow Britain to join in even after it leaves the bloc. Germany prefers it to remain within the EU. As a compromise, both sides agreed for the force to be "linked as closely as possible" with the EU's framework.

*The Meseberg Declaration attempted to chart a middle course between France and Germany's positions, but the rest of the EU's members are still required to debate their proposals. With the divisions within the bloc, even a Franco-German compromise does not necessarily guarantee that all their proposals will be implemented.*

# Italy Holds the EU to Ransom

Whilst Britain has gathered much of the media attention as it entangles itself from the EU, for Brussels, Berlin and Paris, Italy has been the main issue at hand. A member of both the eurozone and EU the Italian economy has suffered from low growth and rising levels of income inequality for the past 20 years. The global economic meltdown of 2008 made Italy's already bad situation worse. Since 2008 none of the coalition governments were able to improve the Italian economy and this has led to the mainstream parties and politicians to lose credibility for more populist parties. Parties who were prepared to disobey the EU austerity and debt measures and put the Italian people first.

On 4<sup>th</sup> March 2018 Italian voters voiced their dissatisfaction with mainstream politics, exacerbating political uncertainty in the third-largest economy in the eurozone. The electoral result gave the anti-establishment Five Star Movement 32% of the vote, followed by the centre-left Democratic Party with 19%, the anti-immigration Northern League with 17% of the vote and Forza Italia with only 14% of the vote. The results made it clear that Italians are punishing traditional leaders while supporting their anti-establishment and Eurosceptic rivals. Together, the Five Star Movement and the

Northern League earned the support of 50% of the electorate. Years of low economic growth, high unemployment, unpopular austerity measures and weak, ineffective governments led to many Italians becoming disenchanted with mainstream parties.

For the EU, this was the first time in the last decade an anti-EU party had won a parliamentary election. The new government openly pledged to challenge the EU's fiscal rules. Their plan for the economy included tax cuts and spending hikes, raising questions throughout the bloc about Italy's fiscal balance. But it took Italy's new anti-establishment government four months to form a government after intense deadlock saw the eurozone's third largest economy narrowly avoid snap elections after a last-gasp coalition deal. The new Prime Minister Giuseppe Conte, 53, was sworn in at the head of the first populist government.

In September 2018 in line with EU rules the populist Italian government presented its first budget. The budget included a raise in spending to finance lowering the retirement age and providing a universal benefit to the unemployed, electoral promises the Five Star Movement promised after a decade of austerity. The budget draft meant an increase

in the country's budget deficit and national debt which is already running at 130% of GDP. This put Italy on a collision course with the European Commission and financial markets and its draft proposal was rejected in October 2018. EU members are meant to follow the bloc's budget rules limiting government debt and deficits. But Italy's new proposals for 2019 ignored previous commitments to reduce both of these, in favour of expanding welfare and cutting taxes.

At more than \$2.6 trillion, Italy has the world's fourth-largest total debt load. At roughly 130% of GDP, it's more than twice what EU rules allow. If investors get spooked and bond yields spike, as happened to crisis-ridden European economies in 2010–2012, Italy's debt payments could spiral out of control. That could mean an Italian default, which would hit banks across Europe that hold Italian sovereign bonds. Italian banks, still weak from the last crisis, hold a lot of these bonds. If they continue to lose value, banks could fail, lending could dry up, and economic growth could plummet again. If Italy takes the unprecedented step of leaving the euro currency and returning to the lira, it would cause massive losses to investors across the continent, potentially triggering another financial crisis.





# Case study: *The Geopolitics of Italy*

Italy's troubles are due to 19th century, three distinct central Papal States were extremely distinct have remained impervious north and centre, whilst the Unemployment, crime, and Italian industry specialises other nations produce more has grown to \$2.6 trillion, these structural issues are an economic slump.

its regional composition. When the country was united in the regions were brought together, the republics of the north, the surrounding Rome, and the southern kingdom of Sicily. These regions to function as a single country as a result cultural divides to change. Italy's economy is today dominated by the south holds over 30% of the country's population. black-market labour are also concentrated in the south. in the mid-to-low consumer goods which China and cheaply. Over the last two decades Italy's debt well in excess of the economy. U n t i l resolved, Italy will remain in

## Conclusions

Scepticism of the EU is at record levels and this is placing a huge burden upon the union. With the rise of anti-EU parties and Britain on the verge of leaving the EU the intellectual case for a united Europe is falling apart. More and more nations are disobeying the EU and the EU is stuck in applying penalties; in a climate where anti-EU forces are gaining more and more traction. Whilst the EU has attempted to move ahead with reforms and expansion, this just belies the truth that many citizens of the EU, irrespective of their leaders have serious doubts over the future of the EU.

# 2019

### **Battle for EU Leadership:**

Elections for the European Parliament will take place in May 2019. They take place at the worst possible time as Eurosceptic forces will gain over pro-EU parties, producing a fragmented legislature. These divisions will, in turn, make it harder to pass legislation. The selection of the new European Commission president will follow and lead to disputes within the bloc as it's divided on the direction of the EU. A conservative commission will likely focus on trade agreements and reducing immigration from outside the bloc, while a progressive EU commission will more likely focus on ensuring greater economic cohesion. Whichever way the EU will try to move forward, it will be divided.







# Global Trade in a Flux

The global trading system was crafted by the US in the aftermath of WW2. The US gathered the capitalist nations in Bretton Woods, New Hampshire, USA, and laid the architecture of the post-war economic world. In the decades after the war, the US set up a system where liberal economies would all benefit from free trade with the US at its centre. Europe joined this system and eventually Japan joined as well. Borders and tariffs gradually fell away as the GATT led on to the creation of the WTO. The globalised world then emerged after the collapse of the Soviet Union in 1991 and with it the end of communism in the international stage. Globalisation provided the foundations for rapid, manufacturing-led growth in such countries as China, which eventually acceded to the US-led institutions.

But as its membership grew and became more diverse the WTO stalled, and can no longer reach a consensus on how global trade should move forward. Trade liberalisation failed to keep pace with the developments of the modern economy. As Western economies developed in areas such as services and digital commerce, the rules at the WTO — strong on goods but weak on services — were left behind. Unable to advance on a multilateral front, like-minded countries began negotiating trade pacts in smaller groups, such as the TPP, which was designed to be the model for a comprehensive modern trade agreement, and the fledgling Trade in Services Agreement (TISA), intended to liberalise that sector among member countries. The WTO remains, merely an enforcer of rules involving the trade of goods.

The first challenge against the trading system has come from the mother who gave it its very birth — the US. The world's largest economy is resisting against the ties that bind it by directly questioning the system. It is challenging the WTO itself by refusing to approve judges for the appellate body that handles trade disputes, while also invoking unilateral trade remedy procedures that have not been used since the 1980s. In 2017 the US withdrew from the TPP, and it began to renegotiate its trade

deals with Canada and Mexico via NAFTA (the North American Free Trade Agreement) and with South Korea (US-Korea Free Trade Agreement).

The US administration under Donald Trump wants to return to a world of bilateralism, where deals are negotiated between two countries instead of many; this is a world that would suit the larger competitors to the detriment of the smaller nations. America's role in the global system is now the source of dissatisfaction for many in the US. By giving the system its birth, by having its currency as the reserve currency, by having a borderless world, this caused investment to flood into the US and helped to create a consistent trade deficit. Today foreign investment in the US exceeds US investment overseas.

*But as its membership grew and became more diverse the WTO stalled, and can no longer reach a consensus on how global trade should move forward. Trade liberalisation failed to keep pace with the developments of the modern economy. As Western economies developed in areas such as services and digital commerce, the rules at the WTO — strong on goods but weak on services — were left behind.*

The primary source of US dissatisfaction is right across the Pacific — China. The world's second-largest economy took full advantage of the trade infrastructure put in place by the US and it has used it as a platform to achieve astronomical growth over the past three decades. WTO membership allowed China to build a global factory, which takes in materials from the developing world and assembles them into products that it sells to developed markets. With no tariff barriers to hide behind, those markets struggle to defend against this influx. The lack of global rules on such modern trade topics as services and non-tariff barriers suit China. Because of its historical suffering at the hands of foreign powers, the Middle Kingdom prizes control and sovereignty above all, and it is particularly wary of any interference with its laws and governance. Trade liberalisation with goods largely involves the reduction of tariffs at the border, while liberalisation with services involves issues inside the border.

A world where the trade in goods is liberalised (allowing China to export its products) and the trade in services is not (letting China keep maximum control) is thus perfect for the Chinese. As a result, China is highly motivated to maintain the status quo and defend the WTO, but it is wary of progress and 'modern comprehensive trade deals,' such as the TPP.



The EU continues to follow the status quo. With a modern and developed economy, the bloc wants agreements with its major trading partners that cover areas such as services and the digital economy. The EU sees itself as a model for other countries to follow and as a result wants to be setting global standards in trade that will be adopted around the world. So whilst it wants to preserve the status quo Europe is pushing to keep moving forward.

In the decades after WW2 Japan was the reluctant liberaliser. It prioritised the export of goods and resisted any attempts to reform Japanese laws or regulations, helping it protect its weak services sector. But now it has been overtaken by South Korea in key trading markets and with China's rapid rise, Japan has decided to join the global conversation. Japan and Europe have both been trying to keep the free trade dream alive by pursuing as many large and comprehensive trade pacts as possible, including a large trade deal between them in 2017. The EU has also signed a pact with Vietnam and has expedited negotiations with Australia, Mexico and one of South America's trade blocs, Mercosur (Common Market of the South). Japan for its part has been instrumental in keeping the TPP (now the CPTPP, or Comprehensive and Progressive Agreement for TPP) alive after the US withdrawal and it hopes that the US can be persuaded to re-join later.

The UK is about to leave the relative comfort of the EU, which receives 43% of its exports and is the source of 54% of its imports. The world's fifth-largest economy will likely find it easy to strike trade deals with manufacturing exporters but in the export of services, where it is strongest, the UK will find its domestic companies are guaranteed little protection abroad by WTO rules. A post-Brexit UK will need join a group of countries, such as Japan and the EU, that are actively signing comprehensive trade agreements and looking to modernise global trade standards to better reflect their economic needs.

India faces a different challenge. A million workers enter its economy every month, India must find jobs for them all. It would ideally like to do this by creating a manufacturing industry the same manner as China and Japan did before it; that aspiration faces many infrastructural, political and geographical constraints. India's strength is in services and it remains weak in agriculture and manufacturing. As a result, it is poorly positioned for the current global trading system in which goods trade is liberalised and services face barriers, and it has long been a difficult and protectionist voice in multilateral negotiations. India will thus be looking with increasing urgency for ways to reduce barriers to its services exports, often by negotiating bilateral pacts. But with the liberalisation of the trade in goods often being the starting point in any negotiation, it will be held back by its innate protectionism.

Global trade is therefore in a flux. The US wants a different global trading system as the one it created no longer serves it. China and the EU, the two possible contenders to replace the US in a new global trading system have differing views on how to proceed, making it unlikely that two of the world's three economic hubs can align as the EU and the US did for so many years. The one regional pact that has momentum — the CPTPP — includes neither the EU nor China. China's equivalent pet project, the Regional Comprehensive Economic Partnership (RCEP), looks hamstrung by the divergent interests of its members. It contains China, which is averse to services liberalisation; India, which only wants to discuss services liberalisation; Japan and Australia, would like to discuss comprehensive goods and services liberalisation in the manner of the CPTPP. With the US no longer willing to lead on the current system of world trade, the field it leaves behind looks disparate and diverse, with many different countries pursuing their own interests and priorities.





# Crypto-currencies

From the Marshall Islands to Russia, in 2018 everyone was on board with the year's hottest trend: digital currencies. Following the boom and now, partial bust of

various private cryptocurrencies, the real and practical roles such currencies could play was hotly debated and has now raised more questions as the euphoria has subsided.

Money has been around as long as humans have existed. gold, silver, bronze, diamonds, fish and pretty much anything that could be accepted as payment has played the role of money. Eventually money emerged independently in every corner of the world. It was however, the British Empire that was influential in laying the groundwork for many countries' modern financial systems. As gold has played the role of money the longest in human history the empire faced the very onerous task of transporting gold to make payments across the empire and with other people. Over time gold merchants in the UK began to issue exchange notes — in effect, paper money — as proof of funds. The system developed into a collection of private banks, each of which issued currency in its own name, and soon drove up inflation as the institutions overprinted currency to improve their own profits. To rectify the issue, the British government chose one bank, the largest, to become the sole issuer of national currency. The modern central bank was born. Thanks to its government-enforced monopoly, the central bank became an arm of the administration over time. It became the safest repository for the funds of other banks, since its fate was tied to and guaranteed by the government's own balance sheet and the source of bailouts when they encountered trouble. At

the same time, as it stopped receiving deposits from private citizens, the central bank ceased to function as a commercial lender on its own behalf and turned its focus solely to its official responsibilities in the larger system. Today, the monetary system consists of two main parts: physical money and digital money. Physical money — cash — is the last direct link most citizens maintain with the central bank through bank notes and coins, which essentially are IOUs tied to the government balance sheet. In the era of European imperialism, each time wars took place, money was needed to purchase arms, pay mercenaries and give bribes; empire went off the gold or silver standard to print their way to victory in war, with WW2 being the last major war. In the final year of the war the US gathered the world's major powers in Bretton Woods, to construct the new global

monetary system amongst other things. The new system, created at Bretton Woods, tied the currencies of every country in the world to the US dollar through a fixed exchange rate. It also tied the US dollar to gold at a fixed rate of \$35 an ounce. The dollar was as good as gold. The Bretton Woods system made the US dollar the world's premier reserve currency. Eventually the US stopped converting dollars into gold due to its spending in the Vietnam War. *In 1971, Richard Nixon suspended converting dollars for gold. Ever since currencies have been mainly fiat based, there was nothing backing them at all, aside from the government's writ. Central banks globally print money at will, which with the technology bubble in the 1990s and then the Internet bubble in the 2000s has led to printing money to become more and more virtual, causing untold problems such as inflation.*

# Electronic Money

Numerous attempts have taken place to create an electronic currency, the challenge was always the fact that money can only belong to and therefore be spent by one person or entity at a time. In the digital era, electronic money is no different than any other computer file, which means that unlike physical money, it can be endlessly copied. Bitcoin was not the first attempt at creating an electronic currency, but it was the first digital tender to gain serious interest and backing.

Bitcoin success was largely due to the efforts of Satoshi Nakamoto, a fictitious name or group, responsible for the “Bitcoin protocol”. Prior to Bitcoin, electronic currencies required a third party, such as PayPal, to determine if one party still owned the money or had previously spent it, thus transferring ownership to someone else. The Bitcoin protocol solved this problem by creating a publicly viewable global ledger, showing the sequential transactions of all accounts using Bitcoin.

Blockchain technology is what made Bitcoin possible. Bitcoins are bought and sold on the Internet at places known as exchanges. Bitcoins are generally stored in a digital wallet and transactions are recorded in a shared public ledger - blockchain. The currency is not controlled by any central bank but is instead managed by an online community. Members with powerful computers are encouraged to maintain the transactional register by ‘verifying the blockchain’, solving complex mathematical equations and adding another ‘block’ of transactions to the existing chain. The process is known as ‘mining’ because the verifier is rewarded with new Bitcoins.

Bitcoin, which first appeared in 2008, induced worry among governments, because national financial authorities have little or no control over the currency, which could become a means of

payment in their economies. As the use of cash decreases, officials fear that cryptocurrencies could soon fill the void. Wary of the solvency of banks — especially in the wake of the 2008 financial crisis — and unable to safely store wealth in physical cash, more and more people have reasons to turn to Bitcoin or one of its numerous derivatives. Governments may as a result lose the ability to influence the money supply for the first time since they granted central banks a monopoly on the issue of bank notes and coins.

The problem Bitcoin and other cryptocurrencies faced throughout 2018 are: is it money or just an investment instrument, or at worst a hoax or a pyramid scam where mostly early founders and creators get rich and others lose? The bubble burst for Bitcoin in late 2018, as there were hardly any places you could buy with a Bitcoin or other cryptocurrencies. You were forced to first exchange it for traditional dollars or euros in other exchange sites to be able to spend it.

The year 2018 saw the rise of mostly private cryptocurrencies, with some countries resorting to regulatory crackdowns. Others began considering whether it’s time to wade into the fray themselves. Several central banks, including the Bank of England and the US Federal Reserve, have begun research into whether to issue digital currencies. Sweden’s central bank, the Riksbank, has led the way in efforts to launch a digital currency, the e-krona, and the governments of many other countries are eager to expedite the introduction of their own cryptocurrencies.

Venezuela has rolled out the most advanced, albeit perhaps least substantial digital currency so far in the form of the petro. As hyperinflation plagued the national currency and the threat of US sanctions, Caracas took a chance with the introduction of the petro.

Beyond the petro, Russia’s



cryptoruble is the central bank’s digital cryptocurrency that is closest to becoming a reality. Russia has a long history with money laundering and illicit fund transfers into and out of the country. Digital currencies have provided a new route for these transactions. Like many of its counterparts abroad, the Russian government has cracked down on private cryptocurrencies as it plans to launch its own digital currency.

Most consequential, though, are China’s efforts to issue a digital currency. Exerting maximum control has long been important for the country’s leaders, and Beijing has exhibited singular determination in stamping out private cryptocurrencies. At the same time, the People’s Bank of China has emphasised its intent to introduce a digital currency that will enable the central government to better track the movement of money.

The monetary system that has emerged over many centuries is undergoing significant changes today. The advent of cryptocurrencies and the imminence of a cashless era are forcing them to innovate and adapt.





# The End of the Dollar?

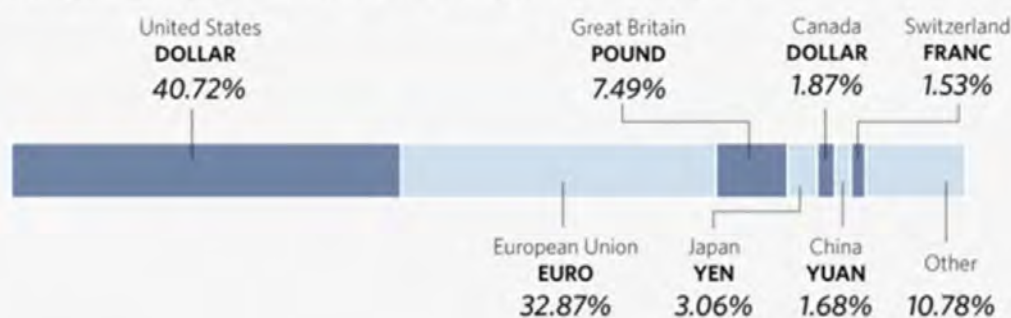
These have been many proposals over the years about replacing the dollar; these have picked up steam since the global economic crisis took place in 2008. They have also increased as China has become a major part of the global economy and as it becomes the world's largest importer of oil. Many nations can see the problem with America's currency being the world's reserve currency and the fact that energy and commodities are priced in dollars, but until now no country was powerful enough to make its currency the new global currency and replace the dollar. Even a group of nations were not strong enough to achieve this. But now China's rise is challenging America's position and nations like Russia are supporting China's move.

The idea to eliminate the role of the dollar in international settlements is not new. In 2009, Russian President Medvedev proposed a new 'world currency' at the G8 Summit in London as an alternative reserve currency to replace the dollar. A report released by the UN Conference on Trade and Development in 2010, called for abandoning the US dollar as the single major reserve currency.

*China, Russia, India, Turkey, Brazil, Venezuela and other oil-producing countries all agreed in 2018 to transact all of their mutual trade and investment in their own currencies.*

## Currencies Used in Global Payments

Percentages of global payments conducted in the leading currencies in January 2017.



# The Dollar: Past & Present

After WW2, Europe was wrecked and the US contribution to the war made a big difference including the US having the largest gold reserves in the world. Along with winning the war, this let the US reconstruct the global monetary system around the dollar. The new system, created at Bretton Woods, tied the currencies of the world to the US dollar through a fixed exchange rate of \$35 an ounce. The dollar was as good as gold. The Bretton Woods system made the US dollar the world's premier reserve currency. It effectively forced other countries to store dollars for international trade, or to exchange with the US government for gold. Being the issuer of the global reserve currency guaranteed international demand for the dollar. This meant the US could print dollars at will, an unlimited supply, since the wider world always needed dollars and would absorb the ensuing inflation.

The US stopped converting dollars into gold due to its spending in the Vietnam war. In 1971 US president Richard Nixon suspended converting dollars for gold. Leaving the gold standard eliminated the main reason foreign countries needed large stocks of US dollars. The Nixon administration dealt with this with a series of agreements with Saudi Arabia from 1972 to 1974, creating the petrodollar and giving foreign countries another compelling reason to hold and use the dollar. This new arrangement preserved the dollar's special status as the world's top reserve currency. The agreement was for the US to prop-up the Saudi monarchy in return for the world's largest oil producer, with the world's largest oil reserves selling oil on in dollars and using its dominant position in OPEC to ensure all oil transactions would only happen in US dollars. The Saudi monarchy also agreed to recycle the many billions of US dollars from oil revenues into American weapons manufacturers and infrastructure companies and also purchase US Treasuries. By 1977, at least 20% of all Treasuries held abroad were in Saudi hands.

Today the US dollar dominates global transactions, whether commodities, finance or payments in global

trade. Oil dwarfs all other major commodity markets combined. In today's modern world every nation needs oil, as oil is priced in dollars, therefore every nation needs US dollars to buy oil. Today when a European nation wants to purchase oil from the Gulf, it has to purchase US dollars on the foreign exchange market to pay for the oil first.

This therefore creates a huge artificial market for US dollars and this is what sets apart the US dollar from every other purely local currency. The US dollar in effect acts as a middleman in countless transactions amounting to over \$5.4 trillion a day that have nothing to do with US products or services. What the US achieved was by forcing oil to be priced in dollars and creating an enormous demand (dependency) for dollars it also became a benchmark for international trade. As all the world needs dollars for oil, this then forced them to also use dollars for international trade. In addition to nearly all oil sales, the US dollar is used for 88% of all international transactions. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) that enables financial institutions to make payments on behalf of companies, governments and institutions is dominated by the US dollar. Almost all nations globally have little choice but to take dollars.

The dollar's position also allows the US to sanction nations that do not follow the US political line or who the US wants to punish. The US can sanction nations where it becomes illegal for financial institutions to sell dollars to such countries, this is something the US has done with Cuba, North Korea and Iran. *"The potential use of the U.S. dollar as a baseball bat has been evident for more than a decade for Russians, Chinese, and Iranians. For this reason, they have been exchanging their dollars for other currencies for years,"* said Federico Pieraccini, analyst with the Strategic Culture Foundation. By 'weaponising' the dollar, he said that Washington risks prompting more and more countries to consider abandoning it as a medium of world trade in a move he said could prove 'devastating' for 'Washington's economic power' in the long run.<sup>35</sup>



# Russia Leads the Call for Change

Russia's regular announcement of replacing the dollar with other national currencies and taking oil payments in currencies has been taking place for some time. But Russia has failed to act upon this or attract other nations to it. But since US sanctions on Russia after its invasion and occupation of Crimea and East Ukraine in 2015 and the fallout from the investigation into Russia's meddling in the US elections in 2016, its voice has grown louder.

International sanctions were imposed on Russia during the Ukrainian crisis by a large number of countries. The sanctions were imposed by the US, the EU and other countries against individuals, businesses and officials from Russia and Ukraine. The sanctions by the EU and US continue today and are regularly reviewed in order to increase or decrease them. These sanctions caused a recession in Russia in 2016. The US steadily ramped up its sanctions against Russia since 2015. Congress has gradually expanded the sanctions and used the 'Countering America's Adversaries Through Sanctions Act,' which passed in August 2017 and placed harsher sanctions on Russia. The legislation not only expanded sanctions against Russia, but prohibited US President Trump from lifting any existing sanctions against Moscow in the absence of congressional approval of a detailed report of

Russia's concessions on the matter.

Following the passing of the act, the US Treasury submitted a Kremlin Report that led to the implementation of harsh sanctions in April 2018 against a number of Russian oligarchs, their companies, government officials, as well as a number of banks. These were very strong measures against Russia and aimed at penalising Russia for alleged US election interference and international aggression, this resulted in Russia's biggest banks being cut off from the dollar and denied Moscow access to foreign debt markets. US sanctions have barred Russia's defence industry and some of its largest companies from getting access to the dollar and this has dramatically reduced the ability of the country's big oil and gas companies to borrow in dollars. This resulted in the rouble falling 18% against the dollar. Threats from Washington also extend to Russia's state-run banks.

Russia's problem is the US is using the dollar to hurt it and Russia is struggling in a financial crisis, due to its dependence on the dollar for international payments. Russia is a major world exporter, especially of energy, wheat and military equipment. Russia also uses the dollar in 58% of its debts, i.e. it borrows nearly half its loans in the dollar. As the US uses the dollar to hurt Russia, it needs to reduce its use of the dollar



and untangle itself financially, economically and monetarily from the dollar. Therefore, Russia is now asking other nations to pay it in currencies other than the dollar.

Russia has concluded it must reduce its dependence on the dollar, and it has taken some actions to achieve this, but it cannot do this on its own as no nation had confidence in the Russia currency. Russia can reduce its use of the dollar, but it will not be able to eliminate its use. This is because not too many nations in the world will want to buy Russian roubles, which fluctuates widely on the currency markets and many in the world do not have confidence in the Russia rouble as a reserve currency. The most Russia can do is force nations to pay roubles on Russia's energy sales, on its own the Russian currency cannot replace the dollar.



# China and the Yuan

The 26<sup>th</sup> March 2018 may go down in history as one of the most significant days in world finance. At 9.00am local time, the first trades in crude oil futures denominated in yuan – China's currency – appeared on the screens of the Shanghai International Energy Exchange. Overall, 15.4m barrels of crude oil changed hands through the new contract. Oil trading powerhouses Glencore and Trafigura participated in the trade, lending their gravitas to the nascent market. The petro-yuan was born.

China has been talking about replacing the dollar for some time. This is despite the fact China's rise had dependent upon its huge exports to the US; this has resulted in China accumulating dollar reserves in excess of \$3 trillion. On top of this China has invested over a trillion of these reserves in US treasury bonds.

From 1979, when China began its opening and reform era until the global economic crisis in 2008, China has benefited from using the dollar in its exports, but in 2008 China blamed the dollar's international role as one of the causes of the financial crisis. China didn't worry about the US using the dollar as a weapon for 30 years. China's huge need for energy and commodities meant it needed a large reserve of dollars and all these goods are priced in dollars. Since 2008 China has been calling for a change in the global reserve currency. In 2009 both Russia and China began calling for a new reserve currency.

As President Trump introduced sanctions upon Iran, after Obama removed these, these sanctions include

penalising anyone that uses dollars to purchase Iranian oil. Trump has warned anyone who trades in dollars with Iran, will also face sanctions. In effect Trump has weaponised the dollar. It has already applied sanctions on many Russian companies.

It is this act that has spurred China to undertake actions to stop using the dollar, especially as it's in a trade war with the US. In March 2018, the Shanghai Futures Exchange launched its first futures contract that is open to foreign investors. This contract, a yuan-denominated oil future, has the potential to become a rival to the dollar-denominated Brent and WTO contracts that serve as the current benchmarks.

As China is now the world's largest importer of oil and since 2015 it's been Saudi Arabia's biggest customer for oil, China has begun to negotiate the purchase of oil with its own currency – the yuan, instead of US dollars with some of its trade partners. Russia and Angola, two of the largest producers of oil in the world, are in negotiations with China on this plan. If China does indeed implement its plan to pay for oil in yuan and these two oil producers go along with it, then it would serve as a major blow to the dollar system. If China could also get Saudi Arabia to accept Yuan, then this would undermine the role of the dollar.

If China could get more oil importing nations to use the petro-yuan in oil contracts, it would mean those nations would not need to stockpile large reserves of dollars as these will reduce in oil contracts, then the dollar's role would decrease in the world.



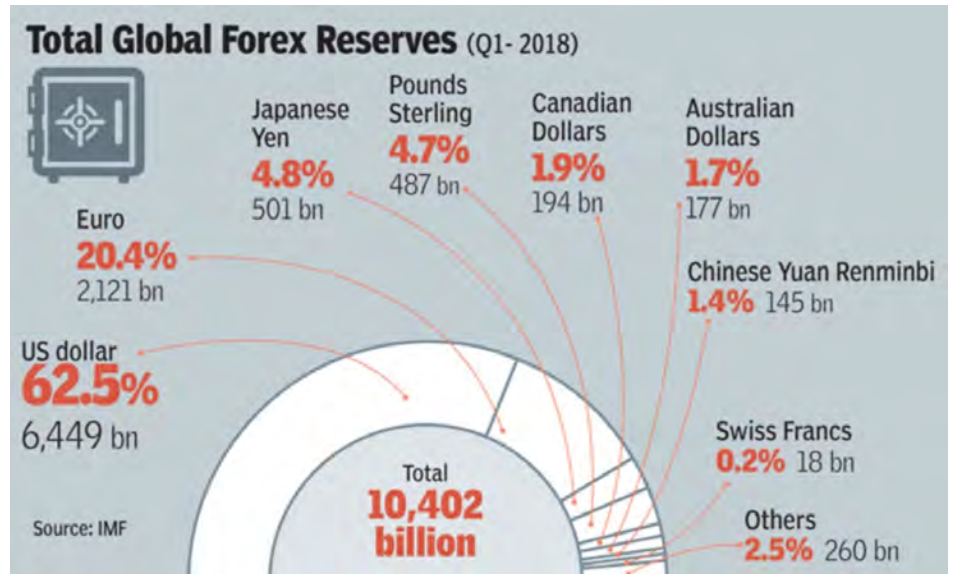


# A New Currency?

The real challenge with replacing the dollar is there are no real alternatives, currently. The euro is the second reserve currency after the dollar. When the eurozone was created in 1999, many predicted that the euro would overtake the dollar. Since then, the divisions among European countries have become far worse. Investors will be reluctant to put their faith in the euro for fear that the currency bloc could collapse at any moment. Although the euro is traded in huge numbers, it is mostly traded within Europe and is therefore really a local currency, not a global one. Another problem with the euro as a reserve currency is the removal of insured bank deposits. This means the EU can confiscate euros held in European accounts to bailout any bank. Since the Cypriot bailout in 2013, the euro as means of payment and reserve currency had collapsed.

The Japanese yen is the world's third most traded currency. During Japan's period of rapid growth in the 1970s and 1980s, its leaders chose to not promote the yen's internationalisation, even though many in the US regarded it as a threat. Successive recessions and the 'lost decade' led to the largest capital flight in world history. As a result, the Japanese authorities put measures in place which made the yen not fully convertible. Japan's prospects are not good due to its falling demographics and continued economic slump and as a result the confidence in its currency is not strong enough to make it the reserve currency.

Currently China's currency is not utilised much in international transactions for the moment. But it has undertaken many actions to internationalise its currency. It has introduced currency swap lines and entered into the IMF's Special Drawing Right (SDR). But for now, few investors or traders have embraced it. In the foreign exchange market, the yuan accounts for only 1.7% of international payments, compared with 40% for the US dollar. China currently has many restrictions on converting its



currency, it has capital controls and its currency is not freely available around the world. When China did make the yuan fully convertible in the last 2010s, the capital flight was so large, full convertibility was shut down. As a result, until these restrictions are not removed the yuan cannot become the world's reserve currency and replace the dollar.

The Canadian dollar, Australian dollar, New Zealand dollar, Pound sterling, Swedish krona and Danish krone, if they combined and floated a global currency, they would only be able to fulfil around a quarter of global transactions. The reserve currency needs to be able to lubricate global trade, these currencies combined cannot fulfil this requirement.

While national currencies have served as global reserve assets, some people have argued that the likeliest successor to the dollar could be an entirely new type of currency. Two developing trends, in particular, have the potential to produce non-national international currencies: the SDR, and cryptocurrencies such as Bitcoin.

The SDR functions as the internal money of the IMF. It derives its value from a basket of five major currencies: the dollar, yuan, euro, yen and pound sterling. Countries have SDR accounts at the IMF, and they can credit and debit one

another using the SDR if they wish to. The fund makes decisions around the basket, such as which currencies are included and what measures to use to calculate its value. In recent years, a proposal emerged to develop the SDR into a currency that could be used by individuals and companies, at the moment, only countries can use it.

Bitcoin, was one of the early leaders in cryptocurrencies. These currencies used a complex system - a distributed ledger mechanism or blockchain technology in which users share the burden of the currency's functioning by offering up their computer power, creating a 'democratic' currency that does not need a central bank to oversee it. A 2015 report showed that Bitcoin insiders expected it to become the sixth-largest reserve currency by 2030. But at less than \$20bn, it appears the bubble on cryptocurrencies is running out of steam.

Both the SDR and Bitcoin face a similar issue: a lack of agency. They both remove a central authority from controlling the issuing of the currency but neither provides the backing that can be afforded by the world's superpower. In reality for the moment there is little alternative to the dollar, but China is making moves to internationalise its currency and in time it will likely challenge the dollar as its economy grows.



# Gold Standard

In 1971, the US went off the gold standard, which meant that it no longer had the responsibility to redeem its bank notes for real money, i.e. gold. It also meant that, as long as it could get people to accept the dollar - essentially a worthless bank note, as currency, they could print as much as they liked. They took full advantage of this fact and transformed the US from the world's greatest creditor nation into the world's greatest debtor nation in under 40 years. The rest of the world followed this example and as a result, no nation is now on a gold standard and all nations are in debt, many of them beyond redemption. The global economic crisis revealed the Achilles heel of many nations who have printed money beyond comprehension.

Some countries, particularly in Asia, are preparing for potential economic crash by loading up on gold, so that when the collapse comes, they'll be able to float gold-backed currencies that will allow trade to continue. Interestingly, some countries are pursuing the gold standard on a non-national level. The US in particular has in recent years, seen several of its states pass laws allowing precious metals to once again be used as currency.

The most interesting of these developments took place in Wyoming in 2018, where the Wyoming Legal Tender Act (WLTA) removed all forms of state taxation on gold and silver coins and bullion, and reinstated precious metals as currency. The act stipulates that transactions made in gold and silver, "shall not give rise to any tax liability of any kind". Wyoming is not the first state to reinstate the use of precious metals as currency. Arizona and Utah have also declared precious metals free of income tax, and more than 35 states have declared gold and silver free from sales tax. (Precious metals are free from any form of taxation in four states currently — Wyoming, Oregon, Texas, and South Dakota.)

The interesting issue here is what has been the motivation for bringing back the gold as a currency?

In the hearings for the bill, the Sound Money Defence League's Jp Cortez stated:

**“With the abuses of the Federal Reserve’s paper money system becoming increasingly obvious, we’re seeing more legislators across America advance sound money legislation.”**

Stefan Gleason, president of Money Metals Exchange, stated in support of the bill:

***“In reality, Federal Reserve Notes are “fake money” because they have counterparty risk. Restoring gold and silver as money will solve many of the problems we are seeing with inflation and runaway debt.”*** More pointedly, when Arizona was dealing with its own bill on taxation of precious metals, then Texas Representative Ron Paul said, ***“We ought not to tax money... It makes no sense to tax money... Paper is not money, it’s fraud.”***

Clearly, legislators in each state that created similar legislation recognise that the US Federal government is nearing the crisis stage and are hoping that they can avoid going down with the ship. By having precious metals in place before a collapse, they potentially provide their states with an insurance policy that will allow them to continue to make transactions at all levels, regardless of the machinations of Washington and the central banks. Whilst much will need to happen for gold to become the global standard, the fact that countries such as Russia and China and US states are accumulating gold reserves, shows the confidence in this metal which has been viewed as money for millennia.





# The Changing face of Development Finance

The modern era of international development began in 1944, when the Allied powers met at Bretton Woods, to devise a plan for rebuilding post-war countries and stabilising their economies. The meeting created the World Bank and IMF, known as the Bretton Woods institutions. For the next 40 years, these institutions — along with the eight similar organisations that later joined them — largely drove international development.

That changed in the mid-1980s, when Foreign Direct Investment (FDI) started growing dramatically. Today, it is the biggest source of external financing for many developing countries, surpassing development assistance, remittances and portfolio investment. Foreign private capital makes up over 5% of GDP across income groups, though the largest FDI inflows go to high-income countries. Along with changing how economies evolve, FDI has become a potent tool for investor nations to expand their influence. Competition for influence in developing countries is heating up, led by China's massive investments in infrastructure projects in Asia, Europe, Africa and the Middle East. The race in development finance is already altering the balance of power and will have major economic, military and political repercussions.

# China Changes the Game

Foreign investment from China has played a central role in this transformation. In 2007, the country accounted for just 4% of global investment flows, but by 2016, that figure had risen to 17%. China now holds nearly 11% of global FDI assets, second only to the US.

Chinese foreign investment has grown in conjunction with its need for natural resources and for better global transportation links beyond its borders. China created the China-Africa Development Fund in 2007 to build energy and transportation projects in 36 countries. Six years later, it announced the BRI, a \$1 trillion project to link land and maritime routes between Asia, Africa, Europe and the Middle East. A lynchpin in China's economic statecraft, the BRI covers some two-thirds of the world's population and involves three-quarters of its energy resources. Major projects under the initiative include roads, railways, ports, hydroelectric facilities, mining, energy and communications infrastructure. Most funding for Belt and Road endeavours comes from the China Development Bank, the AIIB, China's Export-Import Bank, state owned enterprises and regional Chinese authorities.

For China, the BRI is a way to increase connectivity, expand access to natural resources, diversify trade routes and facilitate investment in foreign currency reserves. It will also create work for the country's state owned enterprises, which administer most overseas Chinese infrastructure

and have subsidiaries in nearly 200 states and regions.

For developing countries, the BRI offers a path towards economic growth and in states such as Afghanistan, improved security. The recipients of Chinese investment get all the benefits of improved infrastructure and financing along with an alliance with a top military and economic power. Some countries also like that China isn't as particular about governance, environmental and human rights issues as are the Bretton Woods and bilateral development institutions.

Chinese infrastructure investment comes with some strings attached. Many of the loans that fund the projects favour China at the cost of the borrowing countries, raising the chances of default, which Beijing can then turn to its further advantage. Sri Lanka learned this lesson first-hand when it defaulted on an \$8bn loan for developing the Hambantota Port and had to sell China a controlling stake in the project as a result.

Pakistan, Nepal and Myanmar cancelled \$20bn in planned hydroelectric projects with China in 2017, citing concerns over loan terms, irregularities in financing and changing priorities in the energy sector. To avoid some of these issues, and to reduce its reliance on China, Thailand recently announced plans to create a Southeast Asia infrastructure and development fund to manage jointly with Cambodia, Laos, Myanmar and Vietnam. The



EU, likewise, is considering more stringent processes for screening Chinese investments in technology, strategic infrastructure and natural resources, while US lawmakers support revising the criteria for inbound FDI deals.

The money is only part of the equation, however. For the US and regional allies such as Australia and Japan, China's wide-ranging investment and infrastructure projects also pose a strategic threat. While China downplays the military dimension of the Belt and Road, the defence applications of its expanding infrastructure networks are undeniable. China has built a military base next to the Port of Doraleh in Djibouti, which it has developed under the BRI, and it has similar plans for the Port of Gwadar in Pakistan. Plans for possible military bases in Vanuatu and Papua New Guinea are also in the works.







# The West Reacts

Despite the challenges that China's ambitious development investment presents, the US has neither the means nor the desire to try to compete with the BRI, though it still supports overseas development. In addition to the State and Commerce departments, the Office of the US Trade Representative and the US Agency for International Development, the US Trade and Development Agency, the Export-Import Bank and the Overseas Private Investment Corp. will play critical roles in maintaining US influence internationally through development aid. These organisations will enable the US to continue supporting infrastructure projects worldwide through joint ventures with US firms, loans, private debt financing and political risk insurance.

Traditional financial institutions, meanwhile, are rethinking their approach to development aid. Investors today inject \$1.1 trillion each year into emerging markets — more than the \$900bn the World Bank has spent in total since its establishment in 1944. To stay relevant, the organisation is expanding its financial horizons to partner with sovereign wealth funds, private equity firms and insurance companies that can supplement the government contributions it historically has relied on. China's aggressive use of FDI is a game-changer. The BRI will increase regional connectivity, advance the integration of Europe and Asia, increase China's access to natural resources and help catalyse economic development in the target countries. The effects of these developments will help shape global affairs for years to come.

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## Conclusions

*The global economy is in a flux as the global hegemon is recalibrating the order it built after WW2. Whilst the US laid down the rules for the global order, nations such as China have grown incredibly quickly utilising the system. It is for this reason the US under Trump is abandoning the global order to dealing with nations on a bilateral basis.*

The year 2018 saw attempts to challenge the dollar as the reserve currency, but much will need to happen to budge the US from this role as the sheer scale of currency needed to achieve this is beyond the reach of most nations, even if they combined their efforts.

On everything related to economics China is now coming out top, it is now the world's largest economy (based on PPP), the world's largest exporter and the largest spender on FDI, China is in a strong position to make political use of its position especially now that

the US has begun to abandon the economic order it built in order to deal with the rise of China.

It remains to be seen what architecture China attempts to build and what the US will replace with the order that served it so well for seven decades.





# China: The New Superpower?

*Not a day goes by without China making some headlines. Donald Trump's trade war officially kicked off the battle for the 21st century as the global hegemon moves to deal with the rising power. US military capability is eroding as China makes breakneck defence developments and all publications and research into US military capabilities consider China to be closing the gap. No country has ever developed an economy as rapidly as China has and this is why it is no wonder many consider China to be the nation that will bring an end to the rather short American century.*

*What does China have in store for the world? What is China's strategy? How will China navigate the challenge the US has thrown down. With this in mind, Strategic Estimate 2019 assesses China's grand strategy.*

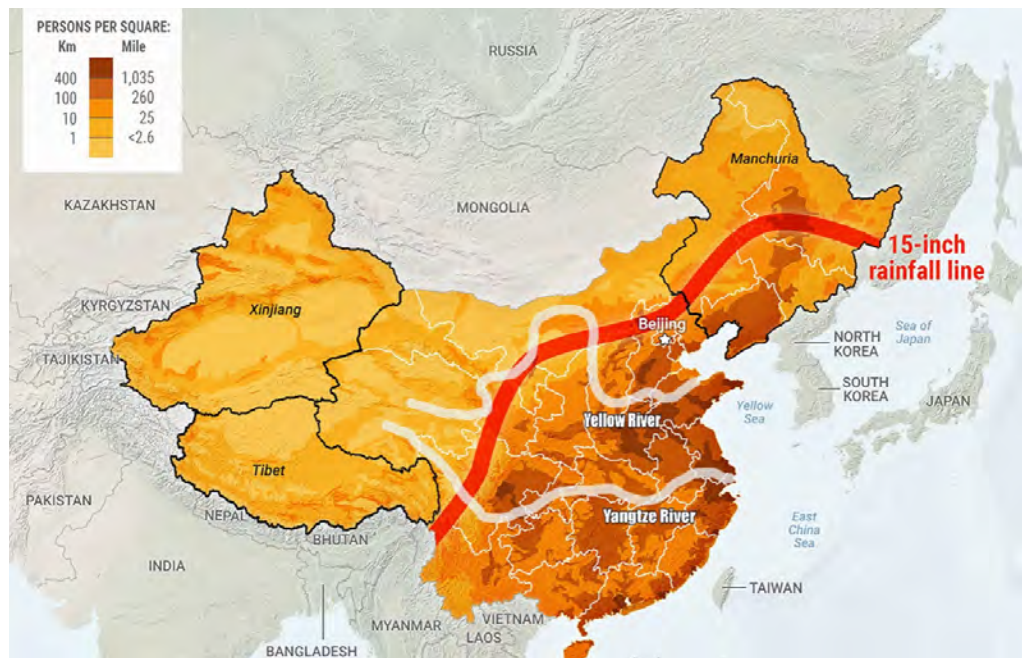


# The Han Civilisation

China has a recorded history of over four millennia. In ancient times societies needed water to survive and for agriculture, they also needed enough rainfall for this purpose. The Han people emerged around the Yellow River in the north of modern China and the Yangtze in the south, along with a third lesser river in the south, the Pearl. This region became the heartland of the Han people. Without the Yellow and Yangtze rivers, China as we know would not exist. When the

Qin dynasty captured both rivers and the surrounding areas in 221 BC, China as a single unit came into being. Over time China became a land of farmers and merchants and established itself as an economic force. Merchants from Japan, India, and the Arab lands and eventually Europe, all flocked to the country to buy coveted Chinese goods such as silk and porcelain.

China's core which consists of arable land and allowed for life to flourish was surrounded by deserts, steppes, jungles, mountains and the sea. The vast majority of China's population historically and today live within one thousand miles of the coast, the other two thirds is underpopulated. The area around the Han heartland



was surrounded by lands of nomads and horsemen. These were non-Han lands surrounding the Han core consisting of Tibet, Xinjiang, Inner Mongolia and Manchuria. This is a vast landmass which surrounds the core area for the Han people. For the Han Chinese to survive it would need to control (expand) from its heartland to these buffers. These regions have historically been where threats to China originated. In the 13<sup>th</sup> century, the Mongols under Ghenghis Khan invaded and occupied parts of Han China until the 15<sup>th</sup> century, when the Han reasserted their authority.

China has been more enclosed than any other great power in history. But this has been both a blessing and curse. The size of its population, when it has secure frontiers and an abundance of resources, allowed it to develop with minimal interaction with the rest of the world. China has been through numerous lengthy periods of its history closed off to the rest of the world, China along with India has also been the world's largest economy for most of human history and so it didn't see the need to engage with the world. The Ming dynasty sponsored maritime adventures of the Muslim admiral, Zheng He, was the exception, but that was brought to an abrupt end in 1425 due to foreign influence entering China, which it didn't need.



The other side of being enclosed in the case of China is poverty. As China has always had a large population, relative to other nations and people, concentrated in a small territory (the heartland) the ratio of arable land to the populace has meant the majority of Chinese were poor, despite periods of prosperity. The population was so poor that economic development driven by domestic demand was virtually impossible for long periods in China's history. International trade was how most of China's dynasties tried to get out of this scenario each time it occurred.

When China did engage in international trade, it did so using overland routes like the Silk Road through Central Asia. China historically has been a land power, not a maritime power. Although China has been involved in the maritime sphere for centuries and Chinese merchants have been active throughout Southeast Asia, the country's geography, natural resources, population pressures and neighbours all allowed and encouraged Chinese leaders to focus their attention on the country's vast territory and land borders. At times of relative stability and security in China's history China avoided expanding its naval activity because it was neither pressed to physically assert its overseas positions, nor did it have the bandwidth. The Silk Road provided enough access to exotic trade and additional resources. The coast of China was often plagued by piracy and suffered occasional raids, but given China's huge interior and its ethnic diversity, China rarely focused on naval power, concentrating instead on coastal defence. Traders and fishermen plied the seas but with minimal protection from the central government.

When the European continent was going through industrialisation in the 18<sup>th</sup> century and fighting over the new world and scrambling over Africa the Chinese saw themselves as a people with a 4,000-year rich and ancient heritage. In Mandarin, Zhongguo, was the Chinese name for China, which means Middle Kingdom.

This was based upon one of the early eras of the Han people dating from 1000 BC, when the Zhou Empire was designated as the Middle Kingdom. The Zhou people, unaware of other civilisations in the world believed their empire occupied the middle of the earth, surrounded by barbarians. The Chinese people still today believe they are the heirs to this ancient civilisation, making China's history very special.

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Zbigniew Brzezinski encapsulated thousands of years of Chinese history in his seminal work, the Grand Chessboard, he characterised China's geopolitics through the ages as "cycles of reunifications and expansions, followed by decay and fragmentations." Every dynastic ruler in China's more than 4,000 years of history has faced the same struggle: to unify and govern an insurmountably vast and disparate landmass under a centralised authority.

China's imperatives came to be:

- Maintain internal unity in the Han Chinese regions
- Maintain control of its buffer regions
- Protect the coast from foreign encroachment





# Century of Humiliation

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By the 17<sup>th</sup> century, the dawn of the maritime era would shatter China. Maritime intruders began arriving on the country's shores. The Europeans encountered a China when it was going through one of its isolationist periods. It was united but relatively poor. The Europeans forced their way in, engaging coastal China in intense trade. This led to a dramatic increase in wealth in the coastal areas that were engaged in trade, but also caused a massive increase in inequality between China's coast and the interior regions. This disparity led to the weakening of the Qing dynasties control over the coastal regions and increased instability and then eventually chaos.

By the 1830s the Middle Kingdom's fortunes had turned. European traders, empowered by the technological progress of the Industrial Revolution, forcibly opened China up to trade on their terms. China dubbed the ensuing period the 'Century of Humiliation,' when between 1839 and 1949, Western powers and then a newly industrialised Japan, forced their way onto the mainland and entrenched themselves there.

By the turn of the 20<sup>th</sup> century China was in chaos. The Qing dynasty had been in a long decline. It was forced to agree to unequal treaties that created foreign concessions in China's ports. The Qing dynasty had lost control not just of the buffer regions but even key areas of the heartland. Regional warlords began to take over areas from the Qing dynasty. Another period of decay and fragmentation was taking place.

If we were to look at China's imperatives at the dawn of the 20<sup>th</sup> century:

- **Maintain internal unity in the Han Chinese regions:** They were physically occupied and even ruled over by 'barbarians.'
- **Maintain control of its buffer regions :** They had lost not just the buffer regions but most of the heartland and core Han region was also lost.
- **Protect the coast from foreign encroachment :** The imperial nations occupied the key ports on China's coast in unequal treaties. Then Japan conquered nearly all of the coastal area and large chunks of the interior.

The four millennia old civilisation was brought to its knees. The Qing government signed a series of "unequal treaties," conceding Hong Kong, Macau, and other major port cities to Western control. The Chinese have never forgotten this shame. This period is carved into the minds of all Chinese, even today their view is, the world's pre-eminent civilisation, China, fell behind the superior technology of the West over the centuries, an imbalance that finally came to a head with the loss in the Opium Wars. This begun the most tumultuous century in the country's history, one that featured an incessant series of wars, occupations and revolutions and one that did not end until 1949.



# Mao's Communist Dead-End

When the Japanese forces surrendered in 1945 the civil war resumed between the communists led by Mao and backed by the Soviet Union and the nationalists, led by Chiang Kai-shek and backed by the US. Mao took the Long March to the interior of China, where he raised a massive peasant army and in 1948, returned to expel the nationalist leaders, who escaped to the island of Taiwan.

In 1950, Chinese forces captured Tibet's border area, forcing the Tibetan government to accept China's Seventeen Point Agreement. In 1956 China repudiated this agreement, forcing the Dalai Lama to flee. In Xinjiang over a million Uyghur Muslims died in clashes that broke out in 1949 between the communist regime who took over and abolished the independence of the territory and annexed it to the Republic of China. The communist regime tried to empty the region's population of Muslims by forcibly re-settling them to China's other provinces. The communist regime supported Mongolian militias during the war with Japan and sent them into Manchuria as guerrilla fighters. After the war ended in 1945 the communist influence over the fighters was enough to bring both Inner Mongolia and Manchuria regions under communist control.

Mao re-enclosed China, re-established Beijing as China's capital, recentralised power and wanting to end the huge inequality between the coastal region and the rest of China, expelled foreigners in the coastal regions. Mao had recreated a united Han China.

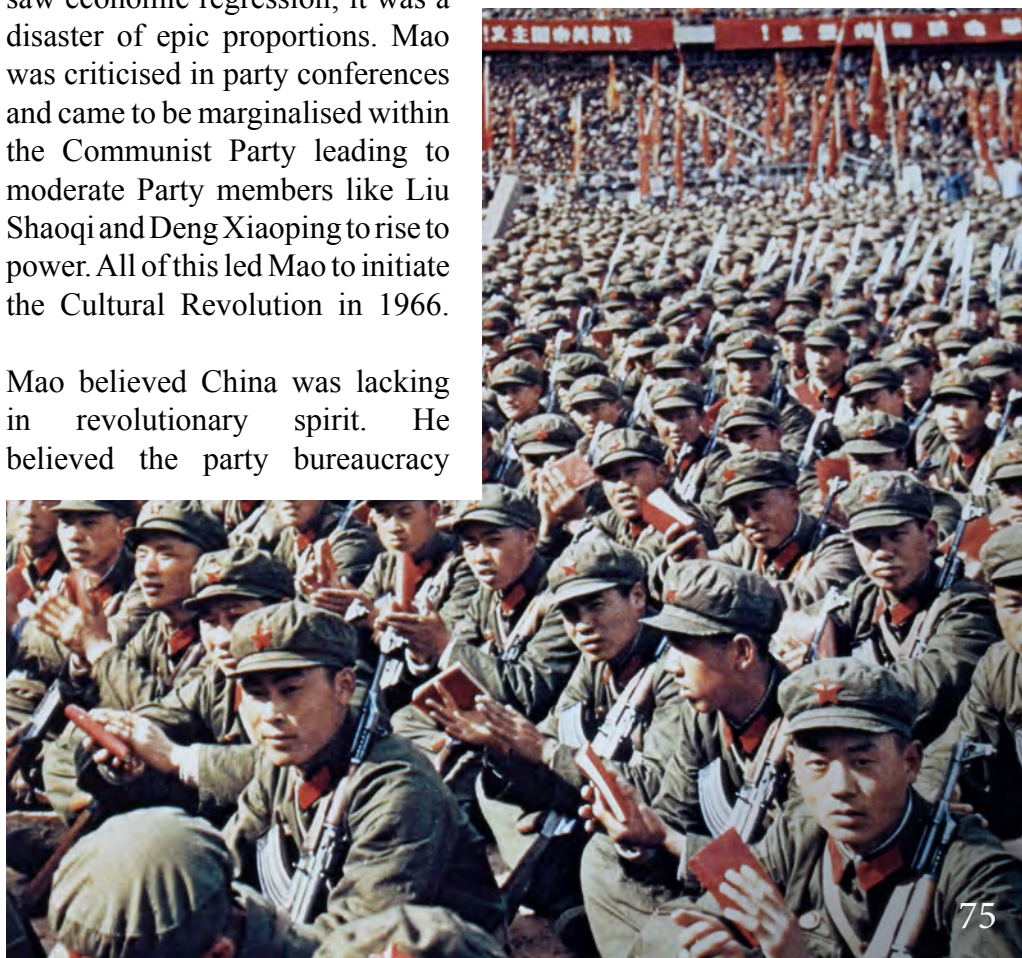
After nearly a century, China's strategic imperatives were secure:

- **Maintain internal unity in the Han Chinese regions:** Internally Mao had reunified China.
- **Maintain control of its buffer regions:** All four buffer zones were under Beijing's control. China was secure from invasion. Controlling Tibet meant that India could not move across the Himalayas. Xinjiang, Inner Mongolia and Manchuria buffered China from the Soviet Union.
- **Protect the coast from foreign encroachment** – Being united internally now meant China controlled its coast and could now marshal the resources and build a navy to protect its littoral waters.

Mao worked to reshape China along communist lines and with this he launched the Great Leap Forward in 1958; which was an attempt to rapidly industrialise. The years of the Great Leap Forward saw economic regression; it was a disaster of epic proportions. Mao was criticised in party conferences and came to be marginalised within the Communist Party leading to moderate Party members like Liu Shaoqi and Deng Xiaoping to rise to power. All of this led Mao to initiate the Cultural Revolution in 1966.

Mao believed China was lacking in revolutionary spirit. He believed the party bureaucracy

was leading China into stagnation. This was based on his belief that the bureaucracy was dragging their feet in implementing his edicts. The Cultural Revolution was a campaign to shake the bureaucracy's hold on power. Brigades of students were mobilised to make war on thoughts that were deemed reactionary. These Red Guard students roamed the country seizing control of government offices, destroying cultural artefacts and terrorising the population. The army stepped aside leaving the party bureaucracy to direct attacks. Many leading communist cadres were killed after being identified as reactionaries. Liu Shaoqi and Deng Xiaoping, were purged, Liu later died in prison. The campaign would not come to a complete end until the death of Mao in 1976, when the military de-mobilised the red guards leading to the end of another period of instability in China's long and turbulent history.





# The Sino-Soviet Split

China was aligned with the Soviet Union from WW2 which led to the bilateral treaty called the 'Treaty of Friendship, Alliance and Mutual Assistance'. Privately, Mao felt Stalin did not view him as an important partner which made Mao view the Soviet Union with suspicion. Due to this, the US saw an opportunity to split the Communist Bloc. The CIA throughout the 1960s was informing the White House of problems between Moscow and Beijing and that the united front was suffering from many problems behind the scenes.



As a result, in 1971, President Nixon's National Security Advisor Henry Kissinger secretly visited Beijing during a trip to Pakistan and laid the groundwork for Nixon's visit to China. After 25 years of no diplomatic relations US President Richard Nixon visited China on the 21<sup>st</sup> February 1972. Over the next decade the US removed the obstacles in the of forming full relations with China. When Premier Deng Xiaoping visited the US in 1979 numerous bilateral agreements, especially in the fields of scientific, technological and cultural interchange, as well as trade relations were signed which gave China access to US technology. The People's Republic of China (PRC) was admitted to the UN in place of the Republic of China (Taiwan).

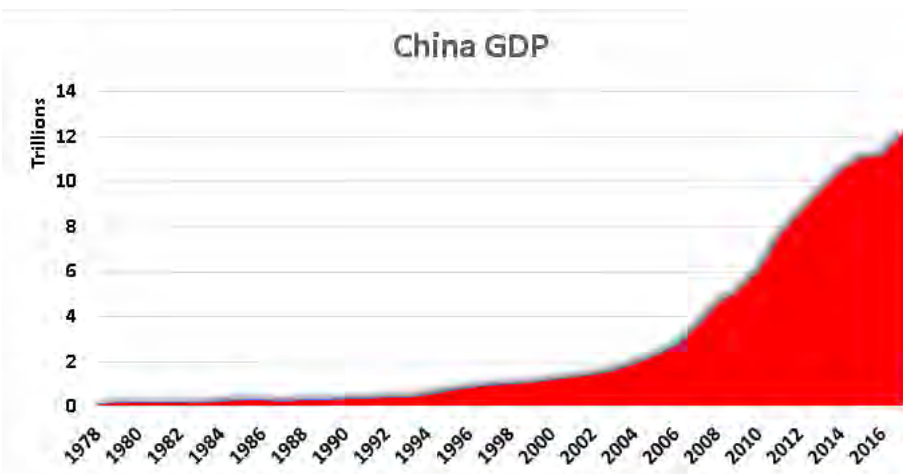
Mao's era came to an end in 1976 when he passed away, a power struggle ensued but Deng Xiaoping outmanoeuvred Mao's appointed successor, Chairman Hua Guofeng and gradually emerged as the de facto leader.

At the end of Mao's era, China's strategic imperatives were:

- **Maintain internal unity in the Han Chinese regions:** The Chinese Communist Party (CCP) was seen as the saviour of the Chinese civilisation after the Japanese surrendered and after the communists emerged victorious from the civil war. The CCP was never viewed as a political party but as the saviour of the Chinese civilisation.
- **Maintain control of the buffer regions:** These regions, on the whole, were restored in the first few years of the CCP's rule. Despite tensions with the Soviet Union and skirmishes, the buffers were never under threat of being overrun under the CCP.
- **Protect the coast from foreign encroachment:** Under the Communist Party China acquired naval ships from the Soviet Union, but its main threat was land based during this period rather than the sea. Under Mao, China's coast was secure.

China was secure under Mao compared to the era before which the Chinese consider their century of humiliation. But China was poor and remained economically backward and well behind the world's powers. This was largely due to its own self-destructive policies such as the Great Leap Forward

and attempts to turn the country into a communist state. China's GDP in 1976 was a mere \$153bn, whilst it possessed the world's largest population of 930m. Spain and Holland – which are the size of Chinese cities had higher GDPs. Over 85% of China's population was in poverty. Whoever was going to inherit China from Mao would be dealing with a country beset with social conflict, disenchantment with the Communist Party and institutional disorder resulting from the chaotic policies of the Mao era.



# ‘Socialism with Chinese Characteristics’

The death of Mao led to the emergence of the reformists led by Deng Xiaoping. Under his leadership an analysis of the nation was undertaken by technocrats from the Chinese Communist Party. The analysis presented at the 3<sup>rd</sup> Plenary Session of the 11<sup>th</sup> Central Committee of the Communist Party of China in 1978, concluded that the prior efforts to develop China, the Great Leap Forward and the Cultural Revolution, had been failures. Mao’s theory of permanent revolution under socialism was abandoned and mass class struggle came to an end. It proposed a new comprehensive policy for China called the “Four Modernisations” of agriculture, industry, national defence and science-technology. This plan was based on a number of underpinnings. The most important of these underpinnings were the following:



1. The realisation that China possessed many of ingredients needed to become of global superpower. It had the agrarian land to be self-sufficient in its food supply. The sheer size of China’s population gives it the ability to become economically independent i.e. the Chinese market is so big that every local demand – both civilian and military could efficiently be produced domestically. If managed properly, such strengths combined could give China the financial ability to develop its armed forces. Through which the country could then become an all-round global superpower.

2. The realisation that China would never realise its potential if did not increase its knowledge base. If China ever wanted to challenge the then foremost powers of the day, America and the Soviet Union, the Chinese workforce would need to make “great leaps forward” in both technical and managerial knowledge.

3. The realisation that its population and in particular the growth of its population, could become the nation’s Achilles heel. If Chinese population growth was not matched with economic growth and employment growth, then the resulting mass unemployment would cause mass poverty, civil unrest and a revolt against the rule of the Communist Party.

The reformists view was that developing China economically was not just an aspiration but a necessity. This comprehensive analysis of China’s state of affairs was translated into policy in 1979 and saw the birth of China’s ‘open door economic policy.’

In 1980, Beijing created the first Special Economic Zones (SEZs) in the coastal Guangdong and Fujian provinces, designed to attract foreign investment in low-end manufacturing by offering cheap land, labour and a variety of tax and other incentives. Success in southern cities compelled Beijing to expand economic reforms, first to the Yangtze River Delta area and later to cities along the Yellow and Bohai Seas. For most of the last 30 years, these coastal clusters acted as Beijing’s experimental (and carefully monitored) interface with the outside world. The coastal zones would ultimately, Deng hoped, generate the wealth necessary to make development of China’s vast, poor interior possible. In doing so, they would ensure social stability and by extension, the Communist Party’s grip on power. The SEZ were so successful that in 1993, 2000 more were introduced.





These Special Economic Zones allowed foreign investment and technology into China and became a new source of wealth for China. It resulted in China becoming an export-oriented economy and the world's workshop. China's trade and investment reforms and incentives led to a surge in FDI beginning in the early 1990s. There were reportedly 445,244 Foreign-Invested Enterprises (FIEs) registered in China in 2010, employing 55.2m workers or 15.9% of the urban workforce. The use of FDIs greatly aided economic activity and job creation. It also allowed for foreign technical and managerial knowledge into China. This is why to this day all foreign companies in China are forced to transfer technical knowledge. The 2010 US-China Economic and Security Review Commission, which advises the US Congress on China related policy issues, confirmed this, regarding China's strategies for developing its aviation industrial base it said: *'Beijing's strategies include the government's heavy political and fiscal support for China's aviation manufacturing industry and the requirement for foreign aviation firms to provide technology and know-how offsets in return for market access.'* <sup>36</sup>

China's economic development has rested upon SOEs. Some 159 large SOEs came to provide the key inputs from utilities, heavy industries and energy resources that facilitated the private sector. These firms flourished throughout the 1980s and helped form the foundation of China's economic development. Beijing continued its reforms in the 1990s, when it dismantled the larger state owned enterprises, breaking them into various competing companies under the guidance of state-backed shareholders. By 2017, the assets of these enterprises alone had reached 72 trillion yuan (\$10.4 trillion), up more than tenfold from 2003 and almost equivalent to China's total GDP for that year. Thanks to easy loans and unfettered access to government funding and assistance, these giants have been able to amass assets in areas where their private and foreign partners were either restricted or found it harder to compete. Since 2013, SOEs have received more than 60% of all new loans in China each year, peaking at 78% percent in 2016. China's domestic market developed largely behind barriers that protected national firms from outside competition, while also letting foreign technology into the country as part of Beijing's strategy to attract outside investment.

At the heart of China's economic development has been the nation's banking system. The government used the national banking system to serve the Communist Party's objectives. The managers of China's state banks were drawn from the ranks of the Chinese Communist Party cadre system, which enabled the party to exert influence over bank lending. In 2015, the top five largest banks in China in terms of assets were state owned entities. The percentage share of assets held by state owned commercial banks together, account for 68.5% of total bank assets in China. Foreign participation in China's banking system is relatively small, accounting for 1.6% of total bank assets. SOEs account for 85% of all bank loans; often SOEs do not repay their loans.

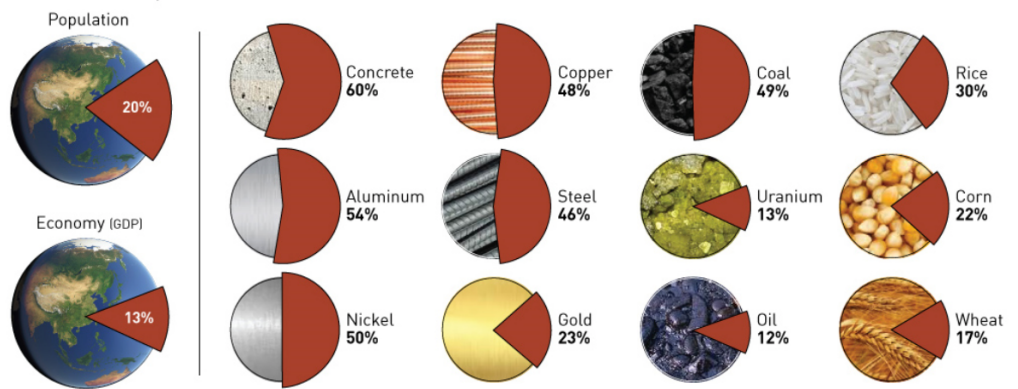
The nation's large savings were funnelled through banks to firms through subsidised rates. In order to qualify for such loans firms were required to maintain high employment (in order to maintain social cohesion); rates of return on capital, building brands, customer service and profit played no part of this process. Anyone who wanted to start a business could get access to subsidised loans and this multiplied China's economic growth. These loans did not look at the ability of the debtor to repay.

The value of the yuan, the Chinese currency, was controlled by the Communist Party to placate the Chinese population. To make Chinese goods more attractive than Japanese and German goods, the Chinese government controlled the value of the exchange rate of its currency with the world, rather than let it float freely. China kept the value of its currency artificially low, which made it cheaper for the world to purchase consumer goods – far cheaper for the world than anyone else. By China undercutting the world, aside from keeping Chinese factories open, this also meant most Chinese citizens had a job. When Chinese citizens have jobs this deals with domestic social unrest which has long plagued the country. Chinese factories made little profits on the goods they exported; due to the low exchange rate the potential profit is lost. According to the Chinese Ministry of Finance, Chinese profits on their exports were about 1.7%.

China's economic rise has been built upon aggressive and cheap exports of consumer goods the world needs. This is why China's rapid economic development has been intertwined with the US. The US, the world's largest consumer, imports the vast majority of the goods that come out of China's production lines. This has resulted in the US trade deficit of \$300bn with China, as a result US dollar end up in China, which today is over \$3 trillion. Such huge reserves have resulted in China purchasing US treasury bonds, which funds America's massive trade deficit. This has now created the problem that President Trump is trying to resolve.

By the turn of the 21<sup>st</sup> century China's economy had turned around over 150 years of economic mismanagement. The huge industrial growth, manufacturing and growth in exports, all required energy and raw materials: China came to consume mind-bending amounts of materials, energy and food.

## CHINA CONSUMES MIND-BOGGLING AMOUNTS OF RAW MATERIALS



Until the early 1990s China was an oil exporter, exporting modest amounts of oil in the Asia-Pacific. By 1993 with China's rapid economic growth in full swing its internal demand far exceeded its domestic production capabilities and ever since China has relied more and more on foreign oil. Oil acquisition is now a process of investment in foreign lands and a creation of an internal oil reserve in case of emergency. Some 85% of Chinese imports arrive by sea, including most of its oil imports. As a result, China has been forced to develop a robust military capability as a blockade would cripple the nation. As China tests its new capabilities in the East and South China Seas, it remains painfully aware that any extended and serious confrontation with the US Navy would likely result in China's sea lane supply and communication effectively being lost.

China's energy landscape is dominated by one fossil - coal. Coal comprises around 65% of China's total energy consumption. China is today consuming an estimated 4bn tons of coal, this is half of the world's total. Hydropower currently provides 12% of the country's power. Most of China's hydropower comes from the Tibetan plateau and surrounding provinces, the size and mountainous terrain of which make building power infrastructure both difficult and expensive. Like

coal, hydropower is hampered by the remoteness and ruggedness of south-western China's geography. China's increased dependence on foreign energy markets will severely test its position on global politics. Political developments in the Middle East and other energy producing regions will all impact China's energy dependency.

The global economic crisis in 2008 showed the strain of the country's low wages high exports model. The economic downturn in Europe and the US - China's two main customers, led to a drop in consumption and exposed China's need for continued exports. China's SEZ's allowed foreign investment and technology into the country and became a new source of wealth for China. But it made the country an export-oriented economy and dependent on foreign countries to continue importing from it. The economic crisis brought to an abrupt end three decades long export boom that the Chinese government micromanaged through years of systematic wage repression and huge subsidies. As a result of the crisis, the portion of China's GDP tied to exports collapsed, from nearly 40% in 2007 to below 24% today. To avoid economic collapse Beijing kept the economy on life support through massive expansion of state-led investment into housing and infrastructure construction. This created a housing boom

leading to huge zombie towns, where high rise apartments were created at a colossal scale, but they were sitting empty as ghost towns. This was not sustainable and Chinese leaders recognised this intervention could not be permanent and the realisation dawned that China needs to create a domestic consumer market which made domestic consumption the economic engine. The country would also need to reduce the dependency on exports. In parallel to this, China launched two new initiatives to maintain the country's position for the foreseeable future.

- Belt and Road Initiative (BRI)** - Xi Jinping announced in 2013 a plan called 'One Belt, One Road' (OBOR) to revive the old Silk Route. At 4,000 miles long, the Silk Route passed through a chain of empires and civilisations and connected China to Europe. China planned to revive the Silk Route with modern transit corridors. At a cost in excess of \$4 trillion this would include high-speed rail lines, modern highways, fibre-optic cables, energy pipelines, seaports and airports. The plan would link the Atlantic shores of Europe with the Pacific shores of Asia. This grand plan was to give industrial sectors such as steel and cement production an outlet to offload their excess materials and capacity. But more importantly trade routes which were to be land based rather than reliance upon the sea.



- **Made in China 2015** - In 2015 'Made in China 2025', was announced as a strategic plan aimed at increasing China's competitiveness in cutting-edge industries and moving the country's manufactured goods up the value chain. Its aim was to cut its reliance on foreign technology and a core goal of Made in China 2025 is to increase the domestic content of core materials to 40% by 2020 and to 70% by 2025. Made in China 2025 stands at the heart of the trade war between the US and China

By 2018, China was not just internally united and controlling its buffer regions, it has its coastal areas firmly under control and was pushing out. China after nearly two centuries has developed an economy which allows it to fulfil the basic needs of its large population as it now has an economy which can achieve this, something that was absent for the last 150 years. China's rapid economic rise has now created a new imperative, one that shifted China out of what had been a near self-reliant capability and into one that left China vulnerable to international involvement. China now has a fourth imperative:

***- Protect China's strategic trade routes, resources and markets from foreign interference.***

China's economic success has been built upon importing raw materials, commodities and energy from the world. It is based on exporting goods to the rest of the world. China is dependent on the global economy, global markets, sea routes and infrastructure. China must secure its vulnerable supply lines through expanding its military presence and extend its international political presence. This naturally brings it into conflict with the US, the global superpower.

China was able to increase productivity, dramatically, in a couple of decades through large-scale capital investment, financed by the country's large domestic savings and foreign investment via the Special Economic Zones. Reforms in China developed gradually, starting in the rural areas with the household responsibility system and township and village enterprises. Steps to open the

economy to foreign trade and investment only started to play a significant role in the 1990s. Financial sector and State Owned Enterprises (SOE) reform was also gradual, gaining momentum only in the mid-1990s. The country's motto was "*crossing the river by feeling the stones*", i.e. partial reforms in an experimental manner, often starting in a few regions, and expanding them upon proven success.

Whilst many have called China's economic model state capitalism, the reality is China has not adhered to any consistent and ideological model of economic development; reform in China was driven by pragmatism and a piecemeal approach to instigating and managing change. China focused on export-oriented growth and gradual liberalisation of certain markets combined with an outward looking foreign investment strategy. What China has been very successful at is the rolling out of its policies. All major reforms have been the result of a process of trial and error on a limited scale. Successful experiments are then scaled up and rolled out across the country. Thus, the establishment and success of four special economic zones in the 1980s was a crucial precursor to its expansion.







# Military Heft

If China wanted to secure its economic success it would need to develop a military fit for this purpose. After WW2 the Chinese military was built upon having more troops than the enemy had bullets, a large ground force, poorly equipped with low tech, to fight a war to drain an invasion of the mainland. The People's Liberation Army (PLA) would compensate for its technological inferiority with its geographic space.

China made major advances in strategic weapons, testing its first nuclear weapon in 1964 and developing a range of land and submarine based weapons. The 1950s, 1960s, and 1970s were a period of frequent conflict and confrontation for China. After the armistice on the Korean peninsula in 1953, China remained engaged in confrontations with the US and Taiwan; fought a border war with India in 1962; engaged in a confrontation with the Soviet Union that peaked with 1969 clashes on the Manchurian border; supported North Vietnam in its wars with France, the US and South Vietnam; and fought its own war with Vietnam in 1979. By 1978, two years after Mao's death, Deng Xiaoping had taken control of China's government and gradually introduced a programme of economic opening and improved relations with the West. This gave China access to Western commercial markets, investment, technology and military assistance. At the same time, China deemphasised military spending, with official defence expenditures falling from 4.6% of GDP in 1978 to 1.5% in 1989 and 1.0% in 1996.

At the end of the 1980s and throughout the 1990s, the Chinese military received several significant shocks. The collapse of the Eastern Bloc and the dissolution of the Soviet Union placed China's Communist Party on the political defensive. In response to the Chinese government's use of the PLA to violently suppress popular demonstrations in 1989, such as the Tiananmen Square massacre, the US and Europe imposed arms embargoes and economic sanctions, halting the military and technological infusion China had been receiving since 1979.

In early 1991, the US overwhelmed the Iraqi military, which had been organised and equipped much like China's. Subsequent developments in Taiwan also caused concern in Beijing. In 1996, China fired short-range ballistic missiles (SRBMs) into the ocean near Taiwan in an apparent effort to deter the election of a pro-independence government in Taiwan. The US signalled its intent to defend Taiwan against a Chinese force by dispatching two aircraft carrier battle groups to the waters around Taiwan. The Chinese military's inability to locate, much less attack, these aircraft carriers demonstrated its inability to successfully use force against Taiwan, should the US intervene. In 1999, the US-led NATO

bombing campaign against Yugoslavia (Operation Allied Force) once again demonstrated the increasing power of US precision-strike capabilities. The war also highlighted the erosion of international norms of absolute sovereignty in domestic affairs; many Chinese viewed the bombing of the Chinese Embassy in Belgrade as an intentional hostile act.

As a result, China began an armed forces modernisation programme in order to bring them on par with the world's powers. Mao's doctrine of 'human wave attacks' - having more soldiers than your enemy has bullets was replaced with a relatively smaller armed force emphasising new technologies. Recognising the need to reform China has ever since been undergoing a Revolution in Military Affairs (RMA), which emphasises a C<sup>4</sup>ISR (command, control, communications, computers, and intelligence) communications, characterised by the wholesale shift to digital, secure communications via fibre-optic cable, satellite, microwave and encrypted high-frequency radio. Since the 1990s, China has focused on and invested in a major reorientation of its military from a massive land army focused on territorial defence to one that emphasises naval and air capabilities to protect China's interests in the East and South China Seas and beyond into the western Pacific. This has included expanding China's reach and a focus on anti-access and area-denial capabilities. China's military modernisation included acquiring and developing advanced weaponry, improving information technology and communications, heightening capabilities on sea and in the air and developing capabilities in new theatres such as cyber warfare and outer space. It also entailed improving Chinese forces' mobility, rapid reaction, special operations forces and ability to conduct combined operations between different military services.

Today, China's leaders have sustained this ambitious and broad-based military modernisation programme intended to transform the PLA into a modern force. China fields the world's largest armed forces, with a standing army of over 2.2m personnel. China's ground forces constitute the largest branch of 1.7m active personnel. China's ground forces continue to undergo significant modernisation and restructuring to deal with potential threats and enhance its land warfare capabilities. Front line troops such as special-forces, marines and paratroopers are being given priority in receiving modern weapon systems and equipment. Other areas of improvement are its battlefield C<sup>4</sup>ISR capabilities with the introduction of satellite communications, wireless networks, and digital radios: army commanders are now able to maintain constant communications with their front-line units while on the move.





# Air Force

Historically China's military was a ground-based army, consisting of a large number of soldiers. The air force and navy played a secondary, almost neglected role. As a result, both China's navy and air force were starting from a very low baseline when modernisation was targeted. The People's Liberation Army Air Force (PLAAF) had a limited role of air defence over the Chinese homeland.

The Chinese Air Force operated more than 5,000 fighters and attack aircraft. Virtually all were based on 1950s-vintage Soviet MiG-17s, MiG-19s and MiG-21s. The air force and navy also operated some 430 light and 145 medium bombers, also based on 1950s Soviet designs, but with the exception of some bombers that carried torpedoes or ASCMs, China's bombers and attack aircraft were equipped only with unguided gravity bombs.

Today, China's air force remains in transition from two decades of modernisation. The sheer size of China's geography requires a large fleet of modern fighters, bombers and significant airlift capability. China has focussed on reducing the size of its air force and focusing on quality and capability. Since the late 1990s, China has begun producing progressively more-advanced aircraft in a strategy to replace its ageing fleet with indigenously developed platforms. China has increased the number of its modern, fourth-generation aircraft from 50 to 600 since 2000, even as it has reduced the size of its overall air force. Military modernisation is about smaller but more up-to-date platforms, and this is what China has been pursuing.

China has been able to achieve all of this from copying platforms it acquired and from stolen intellectual property. In the 1980s, the US partnered with Israel to develop a new combat aircraft based on the F-16. But as costs rose, the US pulled out of the deal, leaving Israel's "Lavi" fighter unfinished. Years later American officials discovered that Israel sold the Lavi's development plans to China. The J-10 is what China was able to build with this information. An updated version of the J-10 entered service in 2017 with an advanced fire control radar array, an increased

use of composite materials to reduce weight and a number of other domestically developed updates that aim to keep the J-10 capable for decades to come.

As the Soviet Union neared collapse in 1989, China seized the opportunity to secure the production line for the Sukhoi Su-27, an air superiority fighter developed to counter American jets like the F-14 Tomcat. China was able to develop the J-11 from this which improved upon the Su-27 design. The Su-27 brought advanced avionics systems and fly-by-wire technology that China was also able to incorporate into later platforms. In 2000, Russia sold China a number of advancements they had made to their own Su-27 platform and China's subsequent effort to incorporate them alongside domestically developed technologies has since resulted in the J-16—a modified and updated Su-27.

*For the time being, China lacks the long-range capability needed for a nation the size of China. The bombers that China produces are medium bombers that are based on a 1950s-era Soviet design. China does not produce long-range heavy bombers.*

The J-20, China's first fifth generation jet is based on the F-22, whose designs were stolen by the Chinese national, Su Bin, who was sentenced to 46 months in federal prison for his crime. The J-20 and F-22 are identical aside from the addition of forward canards on the J-20. Whether the J-20 has the F-22's stealth and radar absorbent material remains to be seen. The F-35 Joint Strike Fighter was also compromised by Su Bin, leading to China's J-31 programme. This jet, still under development, possesses a greater operational range and larger payload capacity than the F-35 it was based on.

For the time being, China lacks the long-range capability needed for a nation the size of China. The bombers that China produces are medium bombers that are based on a 1950s-era Soviet design. China does not produce long-range heavy bombers. To date, China has also been unable to produce and indigenously design a jet engine. The main reason why China does not produce heavy bombers or jet transports is because it has been unable to produce an indigenously designed and developed jet transport engine. Turbojets lack the power and fuel efficiency needed to propel large aircraft over long distances. No Chinese-produced engine has yet been accepted for installation on a long range and heavy plane.<sup>37</sup>

# Navy



The equipment of the People's Liberation Army Navy (PLAN) was similarly outdated. It had about 80 attack submarines, some of which may not have been fully serviceable and all but five were conventionally powered diesel electric boats. Three-quarters of its attack submarines were locally built versions of the Soviet Romeo class, which entered service in the 1950s. All but two of the remainder of its diesel boats were of the only slightly more capable Ming class. China's five nuclear attack submarines were extremely noisy. Its only nuclear ballistic missile submarine (SSBN), also noisy, had never conducted an operational patrol and carried missiles with a range of only about 1,000 metres. PLAN surface ships consisted of 57 destroyers and frigates, only three of which carried even short-range SAMs, rendering China's surface ships virtually defenceless against modern anti-ship cruise missiles (ASCMs).

Since the late 1980s, China has been seeking to develop a 'blue water' navy force capable of operating in the regions beyond its offshore waters. The modernisation of its navy has become all the more important as China relies on the sea lines of communications (SLOC) to secure the country's global network of energy resources and trading activities. China is aiming to develop a relatively modernised naval force that can operate within the first island chain, a series of islands that stretch from Japan to the north, to Taiwan, and Philippines to the south. In the second step, the Chinese navy aims to develop a regional naval force that can operate beyond the first island chain to reach the second island chain, which includes Guam, Indonesia, and Australia. In the third-stage, the navy plans to develop a global naval force by the mid 21<sup>st</sup> century.

During the 1980s China modified first-generation, Soviet-designed vessels using newer naval technologies and then built second and third generation ships based on indigenous designs whilst incorporating mainly foreign weapon systems. This led to the development of the Jianghu-class frigates. The period also saw the upgrading of the Wuhan-class conventional submarines and modification of several Luda III-class destroyers. In the 1990s China purchased four Sovremenny-class destroyers from Russia and put into service ten new classes of indigenously built destroyers and frigates (some of which are variations of one another) that demonstrate a significant modernisation of PLA Navy surface combatant technology.

China has now commissioned into service its first aircraft carrier—the *Liaoning*, which is a refurbished ex-Ukrainian aircraft carrier, previously named Varyag that China purchased from Ukraine as an unfinished ship in 1998.

Although China is designing and building increasingly sophisticated warships, Chinese naval shipbuilders still need to import key components or modules, such as propulsion systems, navigation and sensor suites, and major weapon systems, to outfit these vessels. Such a reliance on imported subsystems creates systems-integration challenges, as well as security concerns stemming from dependence on foreign suppliers. For the moment China's navy is reliant upon land bases for defence, it cannot defend its ships when they go long distances, this is why China remains focused upon the first island chain.

China has made significant progress in modernising its armed forces and this has worried US policy makers who see China challenging its place in its region. The Chinese military started its modernisation drive from a very low position in the 1990s with an outdated navy and air force. Despite developments the balance of military power between the US and China is still predominantly in favour of the US. But on the current trajectory mainland China is secure; China is on the road to developing a military that can protect its global supply lines.





# Politics

For much of China's history in the 20<sup>th</sup> century it was closed off to the world and it engaged little with the international order. Even when it was communist, despite its claims of backing

revolutionary movements to establish communism in the world, this never turned from theory into practice. China opened to the US and then in 1979 its reform and open era saw it engage with the wider world. China sought to gain access and influence in developing countries through military aid, arms sales, and rewards for switching diplomatic recognition from the Republic of China on Taiwan to the PRC. By the early 1990s, China invigorated and broadened its outreach to the world as its fast-growing economy required new sources of raw materials and markets for its exports.

China's insecurity around its own periphery resulted in special attention to its own neighbourhood. China saw its security environment in terms of four concentric circles. The first and innermost ring encompasses China itself (including Taiwan, which it claims). China's second ring contains the territory and bodies of water directly adjacent to China's own land and maritime borders, including portions of Southeast Asia, Central Asia, and South Asia. Chinese leaders believe that peace on China's periphery is essential to domestic harmony, and this leads China to seek extensive influence in these regions and limit influence by outside powers. The third ring includes China's entire Asia-Pacific (including portions of Southeast Asia, Central Asia, South Asia, and all of Oceania), while the fourth ring includes everything beyond Asia—the rest of the globe: the Middle East, Africa, Latin America and the Caribbean.

China came to see the developing world as offering significant economic potential. China wished to work with developing countries to increase its global influence. With expanding international investments and growing numbers of Chinese citizens living, working, and travelling abroad, Beijing has concluded it must work to ensure the safety of these overseas interests.

China's own region – South East Asia, is its most important region. China's economic engagement with Southeast Asia in the past decade has been greater than with any other region in the world. China's trade with the region is weighted much more heavily towards a two-way trade in manufactured items rather than by China's purchase of raw materials. Much of Chinese global trade transits the South China Sea and the Strait of Malacca, and China has significant interests to maintain by securing the maritime shipment and Southeast Asia lines of communication. China also has unresolved territorial disputes with Vietnam, the Philippines, Malaysia, and Brunei in the South China Sea.

Politically, Beijing increased cooperation with its neighbours through greater connectivity and trade. China has staked claims in the South China Sea and aggressively perused these claims by building artificial islands and laying claim to them. It has tried to balance this by promoting trade, investment, and other forms of cooperation with Southeast Asia. It has done this by both bilateral and multilateral moves. In 1991 Beijing established relations with Association of Southeast Asian Nations (ASEAN) which has remained its preferred multilateral vehicle for reaching out to Southeast Asia.

In the past decade, Beijing has steadily increased its involvement in the region through a range of political, economic, and military means. Politically, China has continued to press its territorial claims while increasing links to the region to reassure the region that China's growing influence and territorial claims do not threaten regional stability. From 2003 through 2014, Chinese political leaders visited ASEAN 94 times, making countries in the region among the most visited across the world. Economically, China is advancing large trade and connectivity initiatives and has become ASEAN's most important trade partner. Militarily, China is selling arms to the region and has engaged in more than two dozen exercises with ASEAN countries. All of this has occurred as Beijing began engaging in significant land reclamation activities in the South China Sea from 2013.

Throughout China's history its northern and western frontiers have consistently posed the country's greatest geostrategic threats. By the 1990s when China had developed economically its actions evolved to include security cooperation to the ramping up of economic interactions with Central Asia. Central Asia has been a high priority region for China since 1991 when Beijing first engaged with the newly independent post-Soviet republics. Beijing focused on developing a cooperative and constructive relationship with this bloc of neighbouring states.

China confronted six new and unattached Central Asian neighbours in the 1990s with the collapse of the Soviet bloc and disintegration of the Soviet Union. Mongolia became a nonaligned state in 1989, while Kazakhstan, Kyrgyzstan, Tajikistan, Uzbekistan and Turkmenistan all became independent states in 1991 and affirming the precise boundaries of its expansive land borders to the north and west was the highest priority. But while Russia's economy was in crisis in the early 1990s, the Chinese economy boomed. China was thirsty for energy resources and commodities and the peoples of the six landlocked Central Asian states were hungry for inexpensive consumer goods. Beijing worked hard to resolve border disputes with Kazakhstan, Kyrgyzstan and Tajikistan. China cooperated to demilitarise the border regions and develop confidence-building measures. These efforts led to the formation of an informal grouping dubbed the "Shanghai Five" in 1996 - China, the three Central Asian states and Russia. In 2001, this bloc of five states formalised their association in the establishment of the Shanghai Cooperation Organisation (SCO). The organisation as of late 2015 also included Uzbekistan as a member; Afghanistan, India, Iran, Mongolia, and Pakistan as observer states and Belarus, Sri Lanka and Turkey as dialogue partners.

The SCO was the first multilateral organisation to be established by China. It allowed China to attempt

regional influence, providing a way to get involved without overtly challenging Russia. Over the years Russia's presence in the SCO has come to focus on security issues and China on economic issues.

South Asia is geographically removed from China, but in the 20<sup>th</sup> and 21<sup>st</sup> centuries distances have shortened because of technological developments and mountain ranges have effectively shrunk because improvements in communication and transportation technology have enabled transnational ethno-religious identities to intensify. Advanced weaponry has put China and India closer than ever before in terms of ballistic missile striking distances. India has for most of China's history been a rival, as a result China has always backed Pakistan in the region.

Since the 1990s China has expanded its South Asia policy well beyond simply India and Pakistan, paying more attention to other states in the region, including Bangladesh and Sri Lanka. China's broader economic interests necessitate taking a more comprehensive approach rather than perceiving South Asia only in terms of the India-Pakistan. Although China has continued to align itself with Pakistan since 2000, it has also sought to stabilise relations with India and adopted a more equidistant approach on Indo-Pakistani issues. Despite this, China continues to maintain very close ties with Pakistan.

China's vision is to link the port of Gwadar in Pakistan to Xinjiang with roads, railways and an oil pipeline. Pakistan has drawn up plans to build a railway between Havelian, a Pakistani city close to Islamabad, and Kashgar in Xinjiang. This railway would roughly parallel the Karakoram highway. In 2006, Pakistan awarded a \$1.2m contract to an international consortium to carry out a feasibility study for establishing this rail link, but so far no plans have been finalised to begin construction. In 2006, the Pakistani government presented plans for a 3,300 km oil pipeline between Gwadar and Kashgar

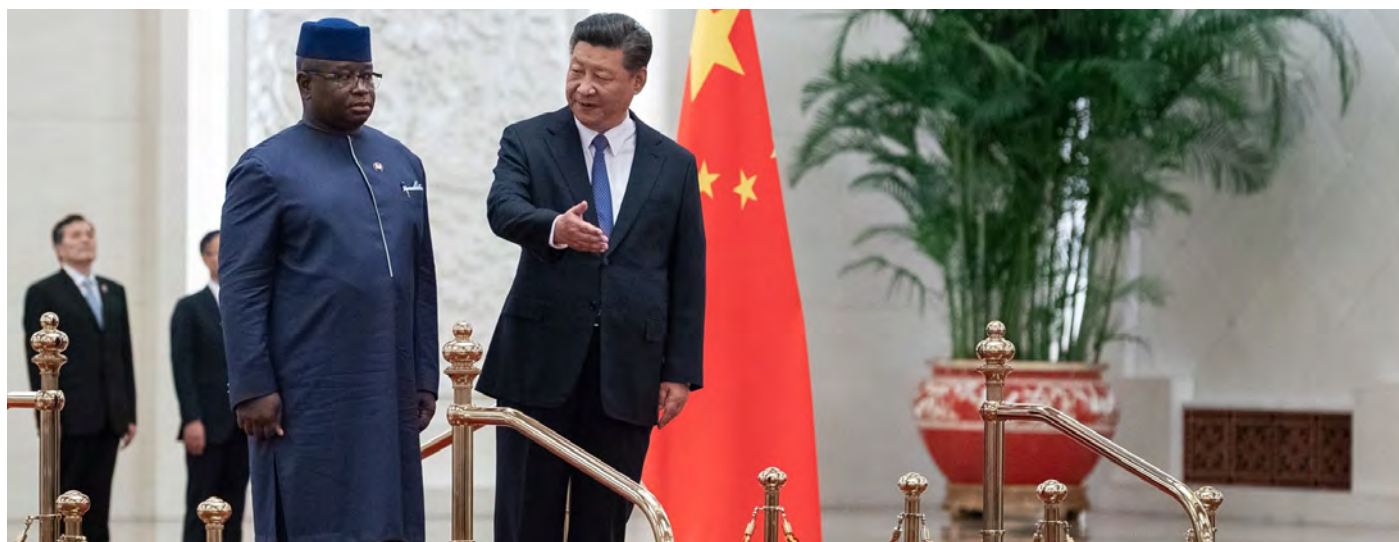


costing an estimated at \$4.5bn to \$5bn. Then in April 2015, Xi Jinping announced the intention to fund \$46bn worth of CPEC projects.

China's national priority is economic development and therefore Beijing has no interest in a state of heightened tensions or conflict in South Asia. China's BRI entails multiple overland routes through South Asia, and Southeast Asia through the Indian Ocean. This vision builds on existing Chinese efforts to develop roads, railways, and pipelines across mountain ranges and through jungles and to build ports and facilities around the rim of the Indian Ocean.

China has been extremely active in Africa for the past few years and this has received much negative media coverage, mainly in the West. Beijing seeks access to natural resources, particularly oil and gas. It also views Africa as a means to enhance international political legitimacy as a global power and leader of the developing world and support the principle of non-interference in sovereign countries' internal affairs. Africa is a new region for Chinese exports of manufactured items.





China ensures ongoing high-level engagement with African countries bilaterally and multilaterally. The latter is through the Forum on China-Africa Cooperation (FOCAC), under the auspices of China, which announces regional engagement strategies, launches educational and cultural initiatives, and unveils large bilateral trade, investment, and aid initiatives and aspirations. China has engaged in a vigorous public diplomacy campaign in Africa to counter negative public perceptions of China.

China as well as the US, both seek security and stability in Africa. China has stressed political independence from outside interference while providing state-backed investment and tied aid focused on infrastructure and natural resource extraction. Both the US and China seek access to natural resources and seek the creation of export markets for manufactured goods. Both hope to improve African economic development through aid, investment, and trade, but Beijing and Washington take different approaches. Chinese and American companies generally operate in different spheres; Chinese firms tend to pursue opportunities in capital-intensive industries using low-skilled labour, such as construction, mining, and manufacturing. However, US firms are involved

in service industries and high-tech sectors such as banking and information technology.

Latin America and the Caribbean is the least important region of the world for China. It is geographically distant and comprises a small share of total Chinese trade. China has three overarching interests in the region. First, Beijing pursues cooperation with Latin American countries to build regional support for China's international initiatives. Second, Beijing seeks expanded trade and investment opportunities to support China's economic growth. Third, Beijing targets strengthened political legitimacy in the form of public acknowledgement in Latin America of Peoples Republic of China (PRC): China being the sole political representative of mainland China and the weakening of Taiwan's footholds in the region.

As Beijing embarked on economic reforms and opened up to international trade in the late 1970s, it also shelved its attempts to foment socialist revolution in favour of developing bilateral relations and links to the developing world. By the 1990s, China switched its emphasis in Latin America from political mobilisation to economic engagement and this is its main aim in the region.

Across the developing world, China is neither in direct conflict

nor working in close cooperation with the US, but there is significant variation by region. In Southeast Asia, Washington and Beijing are in confrontation over Chinese activities in the South China Sea. Outside of Southeast Asia, the US and China appear to be working separately with no real collaboration in pursuit of similar ends but with no conflicts either. The US market is the most important market to China, as its exports more to the US than any other nation in the world. But as relations fray China is now being forced to make adjustments. For long the US viewed China as a cheap location for imports, on the political front it never viewed China as a major player and as such, China never crossed US actions across the world until the last decade with China's claims on the South China seas.

For decades, China prioritised economic development and avoided burdensome international obligations and war. To reassure countries that were nervous about China's growing power, Beijing emphasised the country's "peaceful development" for years. Reflecting the country's changing needs, however, China has increasingly discussed how the nation's revitalisation, which Xi has called the "China Dream," depends partly on the country's ability to shape a favourable international environment.

In the Maoist era, Chinese leaders cultivated relations with the developing world and with either the Soviet Union or the US, as the situation warranted. Because of China's poverty and political isolation, Chinese leaders in the Mao era interacted little with the UN and other major institutions of the international system. However, China's political actions changed significantly following US recognition and the advent of reform and opening-up policies in the late 1970s. China entered the UN, expanded its role in international trade, and took greater interest in international developments. Today, China's leaders appreciate the legitimacy embodied in equitable institutions and fair rules and decision-making processes, as well as the flexibility of an order that allows Beijing to exert influence. However, Chinese leaders resent what they regard as disproportionate benefits that the US receives from existing institutions. They also resist international norms, institutions, and decisions that they regard as privileging Western countries and threatening the importance placed on national sovereignty favoured by China and many developing countries.

In general, when Chinese authorities insist that the country "supports the international order," they are typically referring to China's participation in the established organisations and institutions, such as the UN and the WTO, and its support for many international laws and treaties. By contrast, Chinese leaders and thinkers criticise the liberal norms and values that buttress the international order as a Western "political ideology". A scholar at the Ministry of State Security's Chinese Institute for Contemporary International Relations (CICIR),

Niu Xinchun, explained that China had "*integrated successfully into the international economic system*" but noted "*increasing difficulties with political and ideological integration.*"<sup>38</sup>

China's leaders express support for international institutions that grant China significant influence or, at minimum, influence equal to that of other countries. In the UN, for example, China is granted veto power as a permanent member of the Security Council, which it has exercised occasionally. In the WTO, all members, including China, have an equal vote and ability to initiate the dispute resolution process. In institutions in which China has less influence, however, China's leaders want the allocation of decision-making power to be redistributed so that China has a greater voice in determining outcomes. For many years, China petitioned for the Chinese currency, the renminbi, to be included as one of the international reserve currencies included in the IMF's Special Drawing Right (SDR). In 2016, after meeting the IMF's standards, the renminbi became the first currency added to the SDR list in 15 years.

Where institutional reform in line with China's interests has not been forthcoming or has seemed unlikely, China began building international or regional institutions in which it has a leading role. This is particularly true within its immediate geographic region, where China has created institutions such as the SCO, the AIIB, the China ASEAN and Free Trade Area (CAFTA) and others. In these institutions, China's leaders have greater influence over setting the agenda, which could better enable them to use these institutions to achieve national goals.



China draws a distinction between a "multipolar" order— i.e., one in which non-Western countries have a more equally weighted say in setting norms and making decisions within international institutions and the current order, which China regards as a largely "unipolar" one that privileges the US and its allies. One of the reasons China's leaders' offer reforming representation within existing international institutions, is their belief that the distribution of global power is shifting as emerging markets and developing countries rise.

China contests the aspects of the order that reflect Western values emphasising human rights and democracy or enhancing US military power. China's leaders argue that US military alliances are not part of the international order. Instead, they view these alliances as part of a plan to "contain" China. Similarly, China's leaders criticise some of the liberal democratic norms embedded in the order, especially when they perceive those norms as tension with the Westphalian sovereignty norms that they believe form the foundation of the order.





# Conclusions

After a couple of bad centuries, China is back. It believes, with some justification, that for most of its history it was the largest, wealthiest, best governed, and technologically most advanced society on the planet. China brims with confidence that it can regain this status, which it considers the natural order of affairs, and that it will do so in this century. If we look at China's imperatives they are all more or less secure:

## **- Maintain internal unity in the Han Chinese regions:**

Even as the Han core is extremely complex and diverse culturally, geographically and economically, there is no threat to this region from abroad. It is today as secure as it has ever been.

## **- Maintain control of the buffer regions:**

Modern China has integrated all the areas around its buffer regions, stretching from Manchuria in the northeast through Inner Mongolia, Xinjiang and Tibet. These territories provide strategic depth to China.

## **- Protect the coast from foreign encroachment:**

A foreign invasion from the coast would be at the invaders own peril, but with China's naval development, its coastal areas are secure

## **- Protect China's strategic trade routes, resources and markets from foreign interference:**

This has become an imperative due to China's ability to develop and this is what is causing friction with the US. China had firmly placed its century of humiliation behind it, but rapidly developing in world record time. Where economic development could take multiple decades, China has achieved this in a few decades. China's interaction with the world has been economic led; its foreign policy is fundamentally determined by its economic needs.



## *What is China's view and plan for the world?*

China has no messianic ideology to export; no doctrine of "manifest destiny" to advance; no belief in social Darwinism or imperative of territorial expansion to act upon; no cult of the warrior to animate militarism or glorify war; no exclusion from contemporary global governance to overcome; no satellite states to garrison; no overseas colonies or ideological dependencies to protect; no history of power projection or military intervention beyond its immediate frontiers; no entangling alliances or bases abroad. China firmly believes its values are not universal, but unique to the Chinese people.

China has no values for the world, it has no ambition to become the global hegemon – it doesn't want the entanglements that come with it, it doesn't want to become like the US. China is more than happy with the liberal order, which China integrated into for its own development. But China views the presence of a global hegemon, who uses the liberal order to strengthen itself as a problem. China views the need for multiple powers in the world and even regional balances of powers for a fairer world. China's global view is an objective based judgment, not an ideological one. China's foreign policy is shaped mostly by its economic needs, these economic needs are now forcing it to clash with the US and this is where China will need to develop political strategies to navigate the global balance of power.





# Conclusions

*Despite claims by President Trump to untangle the US from international obligations, the US has been deeply involved around the world and more than ever in 2018 to maintain its global position.*





The US engaged in trade negotiations with Mexico and Canada in the world's largest trade bloc. The US continued to conduct freedom of navigation operations in the South China Sea to challenge Chinese claims. In 2018 in South Asia the US engaged in negotiations with the Taliban to bring the 17-year war to an end. The US in the Middle East turned its back on Iran after working with it in Iraq and Syria. Despite claims that the US is losing its position in the Middle East the US has made use of the Saudi monarchy and the Zionist Entity to achieve its aims of keeping the region firmly within its sphere of interest. The battle for Syria cannot be resolved without the US at the decision-making table and despite Russian claims to have ousted the US from Syria. Russia has no political plan for a settlement for Syria. Despite everything the US has done to shape Turkey's behaviour, the country has not broken relations, despite the rhetoric from Erdogan. The US stationed troops and vessels in Europe against Russian aggression in Eastern Europe. More importantly in 2018 the US officially began manoeuvrings to maintain its position as the global hegemon. Much of the architecture the US established after WW2 is no longer achieving for the US what it used to, and in Trump the US has found a leader who is more than happy to do away with anything with a globalist label.

The US remains the global hegemon, it has political plans for all regions of the world and implements them and adapts them according to the need. The only region where the US is really facing a challenge is South East Asia.

China in 2018 has reached a critical place in its trajectory, it can no longer rely upon the economic drive that gave it so much wealth. China's imperative to protect its supply lines makes it clash with the US. This is why the tariff war is really all about the global hegemon defending its position. China has put in place a strategy to untangle itself from the US and raise its global stature. For the moment however, China remains a challenge to the US in one of the world's regions only, it lacks the capabilities or means to challenge the US elsewhere, unless it can make its strategic plans a success then it would be in a position to engage in global struggle with the US.

Russia in 2018 continued to regain its buffer regions and create the image that it's a global player. It has been successful at creating this image, but beyond its buffers its economic, commercial and defence dealings have not translated into political success. With the US now turning full attention to Russia and China in what it calls great power competition, Russia will have its work cut out as it bleeds from US sanctions.

The former powers of Britain and France are fast moving out of the world's premier nations as they lack the economic and military capabilities to strengthen their political plans. They will likely be replaced by regional powers that are able to build capabilities beyond their regions, there is a good chance their former colonies may outstrip them eventually.

The global balance of power is in a flux as the US works to maintain its hegemony from other powers who are looking to strengthen themselves in their regions. It remains to be seen if these regional powers can push beyond their regions and pose a direct challenge to the global superpower.





A close-up photograph of jagged, translucent blue ice formations under a clear sky.

## *The Fight for Antarctica*

Antarctica is a continent with no government. The closest thing it has is a ten-person office, with a small sign on its wooden door in Buenos Aires that reads “Secretariat of the Antarctic Treaty.” This is the group whose job it is to keep things running smoothly. The continent is twice the size of Australia and contains vast untapped natural resources. Seven countries have laid claims to parts of Antarctica and many more have a presence there. Twelve nations signed up to the 1959 Antarctic Treaty System, agreeing to ban all military activity on the continent and allow for the freedom of scientific endeavours. Any country can now set up a research facility anywhere on the 660,000 square mile island, while mining activity is banned and strict environmental protocols have to be adhered to. But there is trouble on the horizon for Antarctica. Antarctica has significant reserves of oil and gas as well as deposits of coal, chromium and iron ore. According to the US Geological Survey, there could be as many as 36bn barrels of oil and gas buried under the ice and rock, almost impossible to reach now but potentially accessible as technology continues to improve. According to the New York Times, *“an array of countries are rushing to assert greater influence here, with an eye not just toward the day those protective treaties expire, but also for the strategic and commercial opportunities that exist right now”*. Antarctica is fast becoming the next and last region for its mineral wealth.

A large, dense crowd of people at an election, many holding Indian national flags and posters.

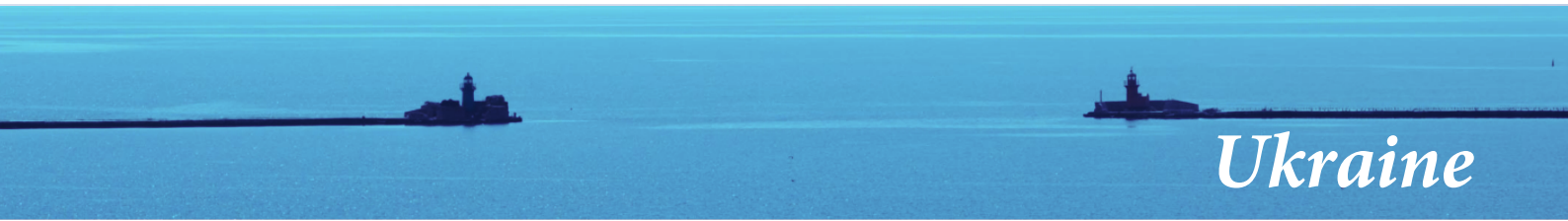
## *Indian Elections*

India has come to play a key role in America’s strategy to contain China. In 2019 Narendra Modi, who swept India’s 2014 general election has his work cut out. After four years the Bharatiya Janata Party (BJP) face a public who are having to deal with the effects of the lack of jobs, falling prices of agricultural commodities and declining rural wages. The tax reforms and the demonetisation exercise have only led to unemployment as it sapped liquidity. Frustration is boiling over which will lead to the BJP resorting to Hindu nationalist issues. Modi will see his majority reduced, but it remains to be seen if it will be enough to force a coalition government.

A close-up of the Union Jack and the European Union flag, with a white knife cutting through them.

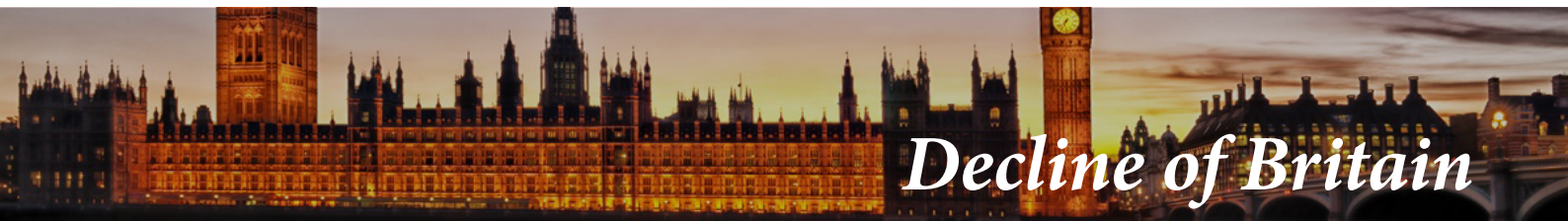
## *Brexit*

The former empire is scheduled to leave the EU on the last day of March 2019. What leaving means remain up in the air. The Theresa May government has attempted to maintain a soft Brexit to maintain as much of a relationship with the EU as possible and have a say in EU decision making. But the anti-EU politicians are using everything at their disposal for a full Brexit. All of this is taking place as Britain’s place in the world is fast shrinking.



## Ukraine

Ukraine is now in its 5<sup>th</sup> year of conflict which became a frozen conflict from when Russia intervened in Syria. The battle over the Sea of Azov in 2018 was the first move since the Crimean occupation in 2015. As matters stand, Russia lost Ukraine to a pro-West uprising, it fought back with the occupation of Crimea and parts of Eastern Ukraine, but the government in Kiev is firmly rooted in towards the West. Ukrainian presidential elections take place in March 2019 and the incumbent president has low approval ratings due to the state of the economy. The election will see the return of Yulia Tymoshenko, who is well positioned gain votes as the people of Ukraine want change. Regardless of who wins its presidential and parliamentary elections, Ukraine seems for the moment to want to continue in its efforts to integrate with the West, something that goes against Russia's interest. In 2019 Russia will need to pull something out of the hat.



## Decline of Britain

The former empire's days appeared to be numbered. It would seem former colonies such as India and countries such as Turkey are having a bigger say on international issues than Britain. Britain's decline since WW2 has seen its economy and military decline as a result it cannot support its ambitions political goals. The Chilcot report which analysed the British government action in the run up to the Iraq war revealed how Britain effectively acted like a vassal nation to the US. If Britain is looking to stay in the game by working with the US in order to undermine it, this is not working. With the departure from the EU looming this spells the end for Britain as a power in 2019. Britain will need to decide if it can reverse its decline, or will it turn into nations like Portugal and Spain.



## Decline of France

France brought liberal values to Europe, it was the French who carried out a revolution and were the original pioneers of change in Europe. But today the world's key philosophers, thinkers and those leading change are generally from the US and not from France. France has seen its economic and military decline since WW2 and has played a largely informal role trying to hold onto its colonies. But it's been superseded by the US in all the places it had influence and with the EU fraying, it looks like 2019 and beyond may very well be *au revoir* for the French.





## *Syria Solution*

The war in Syria no longer drives the international news cycle as it once did. The regime in Damascus has been saved by external help who in turn succeeded in seizing control of most of the country's population centres. But the regime position is very weak for any post-war scenario. After seven years of war and major army defections the army is exhausted and the regime in Damascus is extremely weak and lacks the capability to maintain a grip on the whole country at the same time. Manpower is what the regime lacks, and this is why Hezbollah, Shi'ah mercenaries and Russia have been doing the heavy lifting for Bashar for years. Despite all the weaponry and resource provided to the regime in Damascus, it lacks the manpower to survive after the revolution ends and uphold the political solution. For the US its political solution requires a power in Syria to safeguard its agenda, and this is the challenge the US faces. Despite derailing the revolution, the global and regional powers will struggle to implement their political solution as it requires manpower to maintain these solutions. The regime in Damascus will forever need external financial support as well as physical support to survive. This makes any solution by the world and regional powers even more complex.



## *Iran Crisis*

Iran's economy is choking under US sanctions. The rial has fallen 78% against the dollar in 2018 and inflation is running at over 37%. Unemployment is running at 12% and there is little the clerical regime can do to starve of a recession. The US has made it illegal for international banks to trade with Iran and made it virtually impossible for Iran to get hold of dollars. Whilst the Obama government saw working with Iran as part of its strategy in Syria, the Trump government perceived Iran to be going well beyond what the US wanted from Iran and sees punishing it as the best way to control it. The clerical regime, which will be 40 years old in February 2019, faces probably its biggest test. The sanctions are hurting the masses and the regime will need to cultivate domestic production and exports of non-oil products to take the edge off US sanctions. At the same time Iran will not want to lose its gain in Syria. As domestic unrest grows, this will impact Iranian actions abroad and the 40<sup>th</sup> anniversary year will be one of the clerical regimes most important years.



## *Venezuela Crisis*

The country with the largest oil reserves in the world is on the verge of collapse as its economic and political crisis has deteriorated to the point that many government offices are open for only two days a week to save electricity. Food shortages are causing lengthy queues for basic necessities, the healthcare system has collapsed and inflation, according to the IMF was one million percent 2018. In 2019 the IMF expects it to reach 10,000,000%.<sup>39</sup>

At the centre of the crisis is Venezuela's long-term dependence on one resource commodity, oil. In times of oil booms, Venezuelan governments went on spending sprees that didn't include investment in industry or infrastructure. This made the country dependent on imports. While oil money was flowing, this model works fine, but when oil money stopped, especially now as oil prices are so low, problems begin. This is the pattern in Venezuela for the past few decades and was the case again in the decade under Chavez. Then, oil prices were high, but there was little investment in the domestic infrastructure and very high dependency on revenues to buy imported goods. Venezuela is struggling to pay its debts and pay for imports and 2019 may see the country collapse.



## *Turkish Economic Crisis*

Erdogan rested his legitimacy upon a growing economy, the carpet was pulled from underneath his feet when US speculators began attacking the Turkish lira, exposing the economies weaknesses. Years of borrowing by the corporate sector in dollars had made Turkey reliant upon debt and in the dollar. In 2019 Turkey may very well face an economic crisis. It comes at a crucial moment as Syria is reaching a political solution point and Turkey will need all its capabilities to ensure it takes part in playing a role in whatever political solution is executed by the world powers in Syria. Erdogan has made clear his concerns with the Kurd being part of America's political strategy in Syria, with an economy in trouble domestic problems may mean Turkey cannot give the necessary attention to regional issues. Turkey will see nearly \$60bn in bonds become due for payment in 2019, half of these need to be repaid in dollars. With the exchange rate appreciating, 2019 may see the Turkish economy really implode.



## *Arms Race*

In 2019 and beyond we will see a new arms race. The US and Russia have for long have exchanged accusations of violations, specifically of the Intermediate-Range Nuclear Forces (INF) Treaty. In 2018, the Trump administration declared its intent to eventually withdraw from the pact. Despite America's lead in military matters, in specific areas and niche areas the US lead has been shrinking for some time. The rapid development of disruptive weapons technology combined with the steady deterioration of arms control pacts will accelerate the high-stakes arms race among the US, Russia and China. By the US leaving missiles pacts this will be freeing it to build up a formidable arsenal to challenge China, all while Beijing strategically avoids entering such arms pacts and continues apace with its own build-up in the Western Pacific. The 21<sup>st</sup> century's arms race has well and truly begun.



## *Afghan War Drags On*

President Trump did a U-turn on Afghanistan in 2017, after running a presidential campaign on untangling the US from international wars. He decided to keep the US in Afghanistan, as it needed to see the war through. Gen. Joseph Dunford, the chairman of the Joint Chiefs of Staff, said during the Halifax International Security Forum in November 2018, the Taliban is "not losing right now, I think that is fair to say. We used the term stalemate a year ago, and, relatively speaking, it has not changed much." Whilst in 2018 report from the Office of the Inspector General, US Department of Defense, on 19th November, released a gloomy report on the fight in Afghanistan for the second quarter in a row, citing little progress toward reconciliation. The US has worked for a few years by engage regional nations to stabilise Afghanistan and bring the Taliban to the negotiating table. But this has not been going according to plan. With the great power competition between the US, China and Russia securing Afghanistan becomes even more important, but after seven years, the final resolution is so far away the US will have to continue having a military presence and spending more treasure.





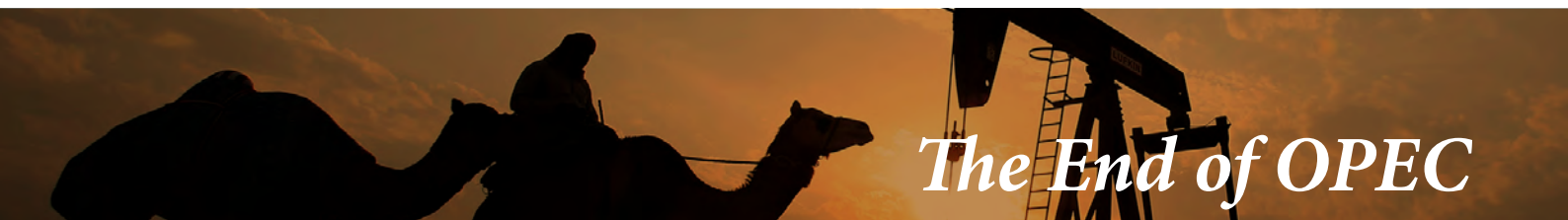
## *Global Currency*

After seven decades it seems the organised challenge to the dollar status as a global reserve currency has begun. Trump's action of weaponising the dollar against Russia, Iran and Turkey, has driven serious actions to look for alternatives to the dollar. The launch of the first petro-yuan futures contract shows how the global dynamics have changed. China is the world's largest consumer of oil and the Petro-dollar was central for the US in making its currency the world's reserve currency. With China being the world's largest exporter, the world's largest economy (by Purchasing Power Parity (PPP)) and now the world's largest oil consumer, it is in a position to demand payments in alternative currencies. The dollar's reserve status has been key to America's position as a global power, this is now under threat.



## *The US and LNG*

The US for decades has been a major oil consumer and importer. Rising Middle East oil prices was considered a tax on American citizens. But this all changed in 2005 when Barnett Shale was drilled using horizontal drilling. The US has now become the world's largest oil producer and in 2019 it will begin exporting LNG and become one of the world's largest LNG exporters with Qatar and Australia. The entry of the US will shake up global energy. Eastern European nations and Europe as a whole will use US LNG purchases to better insulate themselves from Russia. The US will look to profit from the price differentials in the Asian gas market. This development gives the US another tool to engage with the world.



## *The End of OPEC*

Qatar's announcement that it intends to depart from the oil cartel is probably the death nail for the organisation. The organisation has been in decline for many years and this latest act just confirms the organisations declining status. When OPEC was formed back in 1961, the members of the cartel produced half the world oil and secured the petrodollar when they maintained oil prices in the US dollar. But all of this has changed now. OPEC now produces only 40% of the world's oil, the US has surpassed Saudi Arabia in both recoverable oil reserves and total hydrocarbon production and US shale production has put a ceiling on the price of oil. The US is also now a major oil exporter. Oil as a US liability is fast becoming something of the past as the US become a major oil player.



## *New Pipelines*

The Nord Stream 2 and TurkStream are expected to be completed in 2019. These pipelines connect Russia's supply of natural gas to the EU and Turkey, thus circumventing traditional and lucrative natural gas transit routes through Ukraine. This will give Moscow further leverage over the government in Ukraine. With the conflict in east Ukraine frozen, any small development can add up to being substantial which used effectively can lead to the conflict moving to the advantage of the different players involved. This development will allow Russia to make moves that were not available to it previously as its dependency on Ukraine as an energy route will reduce considerably in 2019.

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